10 Tips for Enhancing Your 2012 Executive Compensation Disclosure

With the first year of mandatory Say-on-Pay votes now in the books, companies are turning to their 2012 proxy statements and the preparation of their executive compensation disclosure. As predicted, the shareholder advisory vote on executive compensation required by the Dodd-Frank Wall Street Reform and Consumer Protection Act had a dramatic impact on these disclosures in 2011 triggering several innovative developments which should become more widespread this year.

At the same time, the Staff of the Securities and Exchange Commission's Division of Corporation Finance continues to closely monitor the quality of this disclosure, both to ensure that the information provided is clear, concise, and helpful to investors and to maintain compliance with the spirit and the letter of its rules. The SEC Staff's recent decision requiring Verizon Communications, Inc. to make additional disclosure in its 2012 proxy statement about compensation awarded to its former chief executive officer in past years is a cautionary tale of what's at stake when presenting this information.

While, with the exception of Say-on-Pay, the Commission made scant progress on the remaining executive compensation-related disclosure requirements of the Dodd-Frank Act, investor pressure for companies to address these subjects in advance of SEC rulemaking continues to grow. Undoubtedly, the number of companies addressing their compensation recovery ("clawback") policies or plans to implement such a policy will increase. Similarly, we expect that, in 2012, more companies will disclose whether they maintain a policy restricting the hedging of the risk associated with owning their equity securities. We may even see a greater number of companies begin to address the relationship between senior executive pay and corporate financial performance, a trend that emerged in 2011 and which will eventually dovetail with the Commission's activities in this area.

With these developments in mind, we once again offer 10 tips to enhance the quality of your 2012 executive compensation disclosure. These tips, which are based on our experience in advising numerous companies on preparing their disclosure, as well as what we've learned from our interactions with the SEC Staff over the past year, should help ensure that your executive pay disclosure is sound and effective in the current environment and, in the case of companies conducting a shareholder advisory vote on executive compensation in 2012, supports your Say-on-Pay proposal

As in past years, we've divided our tips between the Compensation Discussion and Analysis and the compensation tables. In recognition of its continued prominence in the disclosure framework and the importance of providing a comprehensive and transparent explanation of your compensation practices and decisions, we've weighted these tips more heavily towards the CD&A.

Enhancing Your Compensation Discussion and Analysis

1. Use an Executive Summary

During the 2011 proxy season, the executive summary, or compensation overview, become an integral feature of the Compensation Discussion and Analysis. The advent of Say-on-Pay served as the catalyst for companies to re-engineer their CD&A and crisply refine their compensation message or messages. Although some companies used a supporting statement to their Say-on-Pay proposal for this purpose, most companies employed an executive summary as the centerpiece of their efforts to persuade shareholders to approve their executive compensation program.

At its core, an executive summary is simply a tool for highlighting the key points that you want to be sure investors take away from their review of your executive compensation program and consider when evaluating your Say-on-Pay proposal. In 2011, executive summaries not only served as an effective way to communicate the central messages of the CD&A, but also as a supporting statement for the Say-on-Pay proposal. We expect them to continue to be used in this fashion in 2012; particularly by companies conducting a shareholder advisory vote on executive compensation at this year's annual meeting of shareholders.

While the precise content of an executive summary will vary from company to company, we recommend that it include a brief description of your company's business results for the last completed fiscal year (either directly or by reference to your Management Discussion and Analysis of Results of Operations and Financial Condition), a comparison of target and actual compensation for your named executive officers based on these results, a description of any material changes to your executive compensation program during the last completed fiscal year, and an overview of your principal executive officer's total compensation for the last completed fiscal year, highlighting his or her variable compensation elements.

We also recommend that you make liberal use of graphics, where appropriate, to communicate this information. In 2011, we saw numerous examples of companies making effective use of tables, charts, and graphs to depict their financial performance and related compensation decisions. We not only expect this trend to continue in 2012, but look for these graphics to become more sophisticated as companies continue to become comfortable with viewing their proxy statement as a communication, rather than a compliance, document.

Finally, remember that the use of an executive summary does not replace the requirement to provide a clear and complete analysis (the "how and why") of your executive compensation actions and decisions in the CD&A. The primary purpose of the CD&A is still to explain the connection between a company's compensation philosophy and policies and the amounts presented in the compensation tables, not merely recite the principal elements of the company's executive compensation program. While the necessary analysis will vary from company to company, an effective CD&A will explain the purpose of each material compensation element, describe how the compensation committee arrived at the specific levels of compensation paid to its named executive officers, and give the reasons for these compensation decisions.

1A. A Special Note With Respect to Your Say-on-Pay Vote

While most companies will be conducting a shareholder advisory vote on executive compensation at their 2012 annual meeting of shareholders, a number of companies will not. These are the companies where, in 2011, shareholders expressed a preference for either a biennial or triennial Say-on-Pay vote and the Board of Directors decided to go along with this preference. Given that we are only in the second year of mandatory Say-on-Pay, we believe that it is advisable for companies that will be conducting a biennial or triennial vote to include a brief statement in their executive summary reminding investors of this fact. This will help eliminate any uncertainty as to whether a Say-on-Pay vote is required or has been overlooked.

2. Remember to Set Forth Your Pay-for-Performance Message

As the 2011 proxy season unfolded, the executive summary to the CD&A evolved from a bullet list of compensation highlights to a fulsome explanation of the company's pay-for-performance philosophy and how that philosophy is reflected in its executive compensation actions and decisions. Given that a majority of the companies that either saw their Say-on-Pay proposals rejected by shareholders or registered significant opposition to their executive compensation programs were first labeled as companies with a pay-for-performance "disconnect," it is not surprising that this topic quickly became the focus of the executive summary.

We expect that investors will continue to emphasize the pay-for-performance credentials of executive compensation programs in 2012. Accordingly, we recommend that you consider orienting the executive summary to your CD&A to addressing this topic. Where your pay-for performance analysis doesn't align with the methodologies used by the proxy advisory firms, it will be critical to spell out how the compensation committee of the board of directors frames this issue. It may also be necessary to explain why your methodology is preferable to that of a third party and how your approach is better able to track shareholder value creation. In our experience, investors are receptive to these analyses, but require that companies make their case clearly and convincingly.

In 2011, we saw many companies illustrate the correlation between company financial performance and executive pay in graphic form. This is likely to continue to be the prevalent means for highlighting these relationships in 2012. And we expect that, in view of ongoing market volatility, many of these tables or charts will be based on realized (or realizable), rather than granted, pay. Thus, one of the challenges in using this approach will be to determine – and explain – how realized pay has been calculated.

Additionally, in selecting a performance measure for these purposes, it's important to ensure that the measure is meaningful, not only from the standpoint of evaluating performance from year to year, but also as it relates to the design of your incentive compensation arrangements. Also, whether you use the compensation of just your chief executive officer, the named executive officer group, or your entire executive officer group, it's important to make sure that the calculation of total pay is sound and consistently applied. Companies that change the measures and/or calculations used to track pay and performance too often risk undermining the integrity of this disclosure.

Finally, note that in 2012 or 2013, the Commission will be implementing the "pay versus performance" requirement of the Dodd-Frank Act. This provision will require companies to disclose in their proxy materials the relationship between executive compensation actually paid and company financial performance. It's not much of a stretch to see how this new disclosure requirement may complement the move towards more rigorous pay-for-performance discussions. Consequently, it may be worthwhile to develop your pay-for-performance message with an eye towards how it may also be used to eventually satisfy this disclosure requirement.

3. Address the Impact of the 2011 Say-on-Pay Vote

The only new provision affecting this year's executive compensation disclosure is the requirement to address in the CD&A whether and, if so, how you considered the results of your most recent Say-on-Pay vote (essentially your 2011 vote) in determining your compensation policies and decisions. In addition, you must also disclose how that consideration affected your executive compensation decisions and policies.

Given the significance of the Say-on-Pay vote as a communication tool for shareholders, we expect that investors – and the SEC Staff – will be looking for this disclosure to better understand how Say-on-Pay is affecting executive compensation design and decisions. Already, we have noticed that several companies appear to have overlooked this new requirement in preparing their 2012 CD&A, so it's important to make sure that you add a paragraph addressing the matter. We recommend that you insert this new disclosure into the Executive Summary to the CD&A or, at a minimum, place it immediately after the Executive Summary to call attention to the item.

Unless your Say-on-Pay proposal received significant shareholder opposition (that is, had in excess of 30% of the votes cast on the proposal voted against the executive compensation program), it's likely that the compensation committee of the board of directors did not make any design changes to your executive compensation program or take any significant actions directly attributable to the vote results. In this case, it's important to clearly state this fact. We recommend that such a statement be accompanied by a brief description of how the company and/or the compensation committee evaluates the vote results following the annual meeting of shareholders to ensure that investors understand how this information gets factored into the compensation-setting process.

We also recommend that you consider addressing your routine engagement efforts with your major institutional investors, even in situations where shareholders have expressed overwhelming support for your executive compensation program. Although this type of disclosure is required only in situations where a Say-on-Pay proposal has received significant opposition (and, then, only by the proxy advisory firms and not the SEC), we believe that this information provides a useful backdrop to any discussion of your Say-on-Pay vote and helps investors better understand how your company communicates with shareholders on executive compensation and other issues of concern.

4. Thoroughly Cover Your Performance Measures and Related Target Levels

No discussion of executive compensation disclosure issues would be complete without mentioning the requirement to provide the details, including the performance measures and related target levels, for your short-term and long-term incentive compensation plans and arrangements. The SEC Staff continues to monitor this area closely and, more likely than not, a review of a company's periodic reports filed under the Securities Exchange Act of 1934 will include a careful review of the CD&A and the discussion of incentive compensation.

Even if the target levels for a performance measure have been missed (which, in the continuing market volatility, may be a real possibility), the Staff stresses that this information may be material to investors (for example, illustrating how the compensation committee of the board of directors sought to motivate the company's executives). Further, if a company has paid its executive officers incentive compensation even though the relevant performance target levels were not met, it may raise questions for investors as to whether the target levels, and related compensation, were sufficiently risk-sensitive since the compensation was paid without regard to the performance outcome.

We continue to believe that you should resist the temptation to claim "competitive harm" to shield your performance measure target levels from disclosure – particularly in the case of short-term incentive compensation arrangements – unless you have a legitimate (and reasoned) basis for your position. When considering a competitive harm claim, you should assess the merits of your argument contemporaneously (and not at the time of a subsequent Staff inquiry). Remember that, where you rely on a competitive harm exception, you should assume that eventually you will be called upon to justify any such assertion to the Staff. Consequently, a critical assessment of your position is not just an academic exercise.

In our experience, when it comes to incentive compensation investors are most interested in two things: how much did you pay and how challenging were the target levels that were set for the associated performance metrics? We believe that if you keep these questions in mind when drafting this section of your CD&A, your presentation will be more robust and effective.

5. Discuss Your Compensation Risk Profile

Over the past two years, compensation-related risk disclosure has become an integral part of companies' executive compensation disclosure. While the disclosure requirement is triggered only where a company's compensation policies and practices create risks that are "reasonably likely to have a material adverse effect" on the company (a fairly high materiality threshold) and then only to the extent that the risks affect the organization as a whole, as a practical matter most companies now include some level of voluntary disclosure on this subject in their proxy statement. Although the content of this disclosure varies, companies tend to acknowledge that the board of directors or compensation committee has conducted a risk assessment on an organization-wide basis. We believe that, for the foreseeable future, such disclosure should be provided – if only to reassure investors that your company is on top of this issue. And, while this disclosure doesn't have to be included in the CD&A, it's likely to be the logical location for any such risk discussion; particularly if, as we expect it will, the discussion focuses largely on your executive compensation arrangements.

Also, don't forget that you may need to discuss compensation-related risk generally in your CD&A. As the SEC Staff has stated on numerous occasions, under the current rules, to the extent risk considerations are a material aspect of your compensation policies or decisions for your named executive officers, you are required to address them in your CD&A.

Most of the companies that acknowledge their compensation-related risk oversight also address how they monitor and manage the risks associated with their incentive compensation plans and arrangements as part of this discussion. Typically, this includes a description of the compensation policies that they have in place to mitigate risk, as well as any specific plan features that serve the same purpose. Many of these features, such as compensation recovery ("clawback") policies and stock ownership requirements or guidelines, which have long been discussed in the CD&A, are now being presented in the context of risk management. Given the continuing interest in this topic, we recommend that these policies and plan features be given prominence as part of any "voluntary" risk-related discussion (whether in the CD&A or elsewhere in our executive compensation disclosure).

6. Explain How You Selected Your Peer Group

Another key area of investor (and SEC Staff) interest involves how companies use comparative data to set executive compensation levels, including the role of compensation "benchmarking." Under the executive compensation disclosure rules, when you benchmark a material compensation element, you are expected to identify the companies that comprise the peer group used for this purpose. More importantly, the Staff insists on meaningful disclosure as to how the peer group was selected and the relationship between actual compensation and data used in any benchmarking study.

For many investors, this information is useful in understanding how a company's executive compensation program works and how the compensation committee of the board of directors reached specific pay decisions. Consequently, we recommend that you devote sufficient attention to this subject when drafting your CD&A. As we have stated in the past, when it comes to the basis for developing a peer group, more, rather than less, information is warranted here. The prevailing concern of many investors is that peer group selection is not as rigorous as it should be. We believe that additional transparency here can overcome this suspicion and bolster the integrity of your competitive positioning analysis.

7. Analyze, Don't Simply Describe, Your Post-Employment Compensation Arrangements

Many companies continue to struggle with the discussion of their post-employment compensation arrangements, specifically amounts potentially payable upon a termination of employment or a change-in-control of the company, in their CD&As. While these companies provide a thorough description of the terms and conditions of these arrangements, they frequently overlook the primary topic that should be addressed in the CD&A – the reason for providing the post-employment compensation in the first place and how they relate (if at all) to the other components of the executive compensation program. In addition, many companies fail to explain the rationale for the structures of these arrangements (compared with other alternatives) and how specific payout amounts or formula are determined. As we have noted in the past, the CD&A is supposed to analyze the reasons for offering these arrangements and how they align with your compensation philosophy and fit into your overall compensation program. The details of these arrangements should be part of your Potential Payments upon Termination or Change-in-Control disclosure, rather than the CD&A.

Enhancing Your Compensation Tables

8. Consider Using a Proxy Summary

The most unexpected development during the 2011 was the emergence of the so-called "proxy summary." Essentially, the proxy summary is an extension of the Executive Summary concept (employed by most companies to summarize the most important aspects of their Compensation Discussion and Analysis) to the entire proxy statement. Most summaries covered the key items contained in the company's proxy materials, as well as a summary of the matters that were being presented for shareholder consideration and action. As an area that isn't subject to any minimum requirements or maximum constraints (other than the SEC's general rules for preparing shareholder solicitation materials), we saw a great deal of variety in these disclosures as companies tailored them to their own specific needs and situation.

Initially introduced by General Electric and Prudential Financial, by the end of year numerous companies were using proxy summaries to provide investors with a high-level overview of the scheduled agenda for their annual meeting of shareholders and to highlight key information relevant to investor voting decisions – such as the backgrounds of director-nominees and the key compensation actions and decisions for senior management.

As companies look for ways to enhance the "communication" aspect of their proxy statement, particularly as it relates to the presentation of executive compensation information, we believe that a proxy summary is an effective way to highlight the key messages that you want your shareholders to receive prior to the annual meeting and, perhaps more importantly, before they cast their vote on your Say-on-Pay proposal.

While the contents of a proxy summary can vary, most tend to include the following items

- the logistical information for the annual meeting of shareholders;
- the meeting agenda;
- the matters being submitted for shareholder action, including the company's recommendation on the matter;
- the background information for the individuals being nominated for election to the company's board of directors
- summaries of the material information about any employee stock or benefit plan being submitted for stockholder action;
- a supporting statement for the Say-on-Pay proposal (if an agenda item);
- an abbreviated Summary Compensation Table (typically covering only the last completed fiscal year);
- the Board of Directors' recommendation for the ratification of the company's choice of auditors; and
- the deadline for submission of shareholder proposals for the following year's annual meeting.

9. Be Sensitive to Tax Payments

While perquisites and other personal benefits have been the principal "hot button" item for investors in prior years, as perquisite practices have begun to taper off tax reimbursement payments and tax "gross-up" arrangements have replaced them at the top of most lists of egregious compensation practices. In almost every situation, investors tend to object to these payments and arrangements, with their level of outrage corresponding directly to the dollar amount involved.

While it's unlikely that a proxy advisory firm or your major shareholders will oppose your director slate or individual compensation committee members, or vote against a Say-on-Pay proposal, solely on the basis of the existence of a tax payment or "gross-up provision," this issue may be problematic. We recommend that you inventory your executive compensation program for any tax payments or similar arrangements and, if they exist, determine whether they constitute a critical component of your program. Where such arrangements have been individually negotiated (and, thus, cannot be unilaterally altered) or play an important role in a specific compensation arrangement (such as in a change in control program), we recommend that you provide a prominent, clear, and transparent explanation of the purpose, operation, and potential cost of such arrangements.

10. Streamline Your Termination and Change-in-Control Disclosure

Post-employment compensation arrangements, particularly those associated with a termination of employment or a change-in-control of the company, continue to be an area of investor concern. Given the complexity of these arrangements and the potential for salacious media headlines, we believe that, after the Compensation Discussion and Analysis, this is the disclosure area that requires your closest attention. It is imperative that your descriptions of these arrangements be easy to follow and understand, and that the estimates of potential payments and benefits be clear and accurate. For example, instead of providing a detailed description of each arrangement, consider using a single composite description of your arrangements and the corresponding triggering events, simply highlighting significant variations between named executive officers. Also, we have found it prudent to avoid the use of the technical jargon that typically governs these arrangements. Instead, use simple descriptions of these terms and refer investors to the source documents for the more complete definitions.

We also recommend providing enhanced explanations of how the estimates of potential severance and change-in-control payments and benefits were calculated; particularly the assumptions that may have gone into your computations. This information may prove valuable both for purposes of validating these estimates as well as for explaining any variances with the actual amounts paid in the event that a termination or change in control occurs. Finally, the executive compensation disclosure rules do not require that the Potential Payments upon Termination or Change in Control disclosure come at the end of your executive compensation disclosure section. This placement is largely a result of where the disclosure requirements fall in the rules themselves. Given the interest in this information, consider moving it forward – including it immediately following the Summary Compensation Table is one possible alternative.

Need Assistance?

Compensia has had significant experience in helping companies to prepare their executive compensation disclosure. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in preparing your executive compensation disclosure, please feel free to contact Mark A. Borges. ■

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