



## SEC Offers Guidance for 2008 Executive Pay Disclosure

**W**ith the first proxy season under the SEC's new executive compensation disclosure rules now in the books, the Staff of the Commission's Division of Corporation Finance has issued a report summarizing its observations from a review of the proxy statements of 350 large and mid-sized public companies and offering guidance to assist companies in preparing their 2008 disclosure. The report, which largely distills the comments sent to the individually reviewed companies, emphasizes two principal themes:

- The Compensation Discussion and Analysis, the de facto centerpiece of the disclosure, must address how and why a company implemented its executive compensation program and reached its specific pay decisions for the year; and
- The disclosure is to be presented in a manner that makes it accessible to both the professional and the lay reader; thus, when preparing the CD&A and the required tables, well-organized, easy-to-follow presentations written in plain English are critical

Like the comment letters themselves, the report focuses primarily on improving the CD&A, the new principles-based discussion of a company's compensation objectives and policies for its most senior executives. While the report touches on the required executive and director compensation tables, given the rigidly formatted nature of this disclosure it offers little guidance beyond a general reminder to pay close attention to the highly detailed and technical instructions that govern the tables. Consequently, aside from adding an additional year's information to the Summary Compensation Table and, perhaps, enhancing one or more of the supplemental disclosure tables to make

them easier to understand, most companies are likely to find that their primary challenge in preparing their 2008 disclosure will be meeting the expectations of the SEC (and investors) in their CD&A.

### Enhancing the CD&A

Given the abrupt shift from the former (and much more limited) Board Compensation Committee Report, we did not find it surprising that most companies struggled in drafting their initial Compensation Discussion and Analysis. Not only was the concept of "principles-based" disclosure relatively new, it was further complicated by the expansive scope of the new report as well as the mandate that it be written in plain English. Many companies found that they simply did not possess the detailed information about their program design and pay deliberations needed to analyze their compensation-setting process. Others were unsure how to explain specific pay elements (for example, annual bonuses) that were decided largely on a subjective basis. As a result, most CD&As described the overall framework of their program and the design and structure of each individual pay element, but offered minimal analysis of how and why specific decisions were reached.

The Staff report reminds companies that the primary focus of the CD&A should be on explaining and analyzing the material factors underlying the specific compensation policies and decisions that are presented in the disclosure tables. In other words, instead of describing how a compensation element (for example, base salary) is generally handled each year, the CD&A should explain how the board of directors or the board compensation committee arrived at the specific amounts that were paid to the senior executives during the past fiscal year (and as reported in the Summary



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Compensation Table). General descriptions of decision mechanics or the material terms and conditions of incentive or equity compensation plans and awards should accompany the disclosure tables themselves rather than be included in the CD&A.

The report also devotes considerable attention to the disclosure of the metrics used in annual and long-term performance-based compensation arrangements. In our experience, this proved to be the most challenging issue for companies during the 2007 proxy season, with nearly half electing not to disclose their specific corporate and/or individual performance targets on the basis that this disclosure would result in competitive harm. While the report reflects the Staff's longstanding position that performance targets are to be disclosed when they are material to an understanding of a company's compensation policies and decisions, it also makes two key points about this disclosure that we believe should make it somewhat easier for companies to address this subject in the future.

First, disclosure of performance targets is required only if they are a material element of a compensation arrangement. This year, in focusing on whether disclosure would result in competitive harm, most companies overlooked this threshold question of materiality. Upon reconsideration, many companies may find that it is not necessary to disclose their performance targets to provide investors with a full understanding of their plans and awards. Second, the Staff is not seeking to force companies to replace qualitative or subjective performance criteria with purely quantitative or objective ones (which, presumably, would be easier to describe). Instead, the rules require only that companies explain the way in which qualitative inputs are ultimately translated into objective pay decisions. In other words, if, after assessing the results of any enumerated performance criteria, the board or compensation committee exercises its business judgment to set the actual pay amounts, it is only necessary to say so (along with any material factors that may have influenced the ultimate decision)—it's not necessary to attempt to reduce this process to a formulaic explanation.

Where a company elects to omit otherwise material performance criteria from its disclosure, it is expected to discuss how difficult it will be for the executive or how likely it will be for the company to achieve the undisclosed target levels. While there is no prescribed approach for satisfying this requirement, the report suggests that this disclosure should put into context the difficulty presented by the required targets. For example, semi-conductor companies, which, given the cyclical nature of the industry, have traditionally faced challenges in setting meaningful long-term performance targets, will probably find it useful to refer to their historical experience (and the outcomes from prior award cycles) when forecasting the difficulty posed by the current undisclosed targets.

The report also notes that companies will need to put more emphasis on their descriptions of benchmarking and peer groups in their 2008 CD&A. While most companies disclosed their use of peer groups (and, when practical, identified the companies comprising the group), many did not explain the reasons for selecting the companies to which they compared themselves. This explanation, along with information substantiating the selection, will be expected next year. In addition, where benchmarking is used, it will be important to explain exactly how and for what purpose. General statements about benchmarking are insufficient. As with other aspects of the CD&A, the expectation is that companies will provide a detailed explanation of how and why they measure their tentative and final compensation levels against their competitors and the market.

Finally, the report reminds companies that the CD&A should cover all elements of their executive compensation program, including retirement benefits and severance and change-in-control arrangements. While most companies offered a description of the key provisions of these arrangements, few provided the required analysis of how they fit into the overall executive compensation program (or were aligned with the prevailing executive compensation philosophy) or how their specific terms and conditions were determined. Given



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the heightened visibility of these arrangements under the disclosure rules and their relative importance to investors, this section of the CD&A is likely to be very different next year.

### Improving Presentation and Clarity

The report's clear message that companies will need to refocus their CD&A on the specific compensation policies and decisions for the past fiscal year creates an apparent conflict with the SEC's other key message from this past proxy season: that the initial round of executive compensation disclosures were too long and complex. Anticipating the tension that exists in trying to reconcile these competing objectives, the Staff encourages companies to consider different ways to present their 2008 disclosure, both to promote clarity and to reduce length. As the report observes, many companies used supplemental charts, tables, and graphs to enhance the required disclosure. In almost every case, the Staff found this additional disclosure to be helpful.

Our own experience confirms the Staff's recommendation. In our view, most companies will benefit from using graphics in their disclosure, particularly in the CD&A, as a way to both communicate difficult concepts effectively and to offset the inevitable length that will

come from a more detailed discussion. Tabular presentation of the required severance and change-in-control information (often the second longest section of the disclosure after the CD&A) is also useful as a way of making this information more accessible to investors.

Although the comment letters themselves didn't address the use (or misuse) of plain English principles, the report gives considerable attention to this subject; an unmistakable reminder that the SEC continues to view this as an essential component of effective disclosure. More significantly, the Staff, perhaps anticipating the likely backlash from its dictate to focus on the analytical aspects of the CD&A, points out that the additional analysis shouldn't merely be added to the existing discussion, but, by adhering to sound plain English concepts, should replace much of the current CD&A, leading to a shorter, more concise, and potentially more relevant discussion.

### Final Thoughts

While much of the recent media attention on the Staff comment letters and subsequent report appear to intimate that the business community largely failed to meet the Commission's expectations with their 2007 disclosure, in our view that interpretation is much too

### Tips in Preparing Your 2008 Executive Compensation Disclosure

- Don't forget to use plain English—this means more than just clear and simple prose; consider how the use of charts, tables, and graphs can enhance your disclosure
- Use your CD&A to explain how your program actually worked—lengthy descriptions of plans and process mechanics should be moved elsewhere; draft the CD&A as if you're explaining your disclosure tables to an interested third party
- Make sure you understand how your performance-based plans work—an effective discussion will require understanding both the plan's objectives and its operation; if a plan can be fully explained without discussing the performance targets, they may not need to be disclosed
- Don't camouflage perquisites—even if you only have a few, explain why they're offered in the CD&A; use a table to disclose (it avoids the impression that you're trying to hide something)
- Keep your severance and change-in-control disclosure short—don't muddy this disclosure with complicated descriptions; general explanations are sufficient; use a single table to report estimated payments and benefits



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harsh. Overall, companies did an exemplary job complying with a new and exceedingly complex set of requirements. It's important to remember that, except for some general statements by SEC officials going into the proxy season, companies were largely left on their own to draft their first CD&A. Now that the Staff has had an opportunity to examine a broad cross-section of these initial efforts, it has weighed in with its own views of what the rules require. Armed with this additional in-

formation, we should see noticeable improvement in next year's CD&As as companies begin to move closer to the Commission's vision for this report. ♦

To obtain a copy of the report "Staff Observations in the Review of Executive Compensation Disclosure," [click here](#).

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### About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management. Formed in 2003 by a group of leading executive compensation experts with more than 60 years of experience, our mission is to offer Thoughtful Pay™ solutions in an ever-changing executive compensation landscape.

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