Suggestions for Proposed Regulations S7-03-06

During the SEC's open meeting on 17 January 2006, premiering the new compensation disclosure proposals, one of the commissioners, in questioning why retirement benefits would not be included in the Summary Compensation Table, elicited a response from Alan Beller, the chief architect of the proposals, saying that they did not want to try and square the circle and include future compensation in the Summary Compensation Table. Unfortunately, the proposals already do this by including in that table the "present value" of equity awards, rather than any amounts that have vested, or profits that were made, during the fiscal year in question. These latter figures, the true present compensation from equity awards, are being placed in a different table. Simply, the SEC is proposing that a new Total Compensation figure, that will be shown in the newly-designed Summary Compensation Table, will include a mix of both current, actual compensation and future, uncertain compensation.

This is all the more difficult to understand because the commission clearly understands that the proposed Summary Compensation Table is largely intended to present compensation paid currently, current earnings from other compensation plans, and "the dollar value of all other amounts earned during the fiscal year pursuant to incentive plans". Why, then, should it also include amounts "awarded" in the year but not earned?

Enough complaints

But enough of complaints. While there are problems with the proposed regulations, they are easy to correct, and any problems are far outweighed by the enormous leap forward in disclosure that these regulations will present.

The change to regulations covering compensation-related 8-K filings will also be beneficial because it will collect all employment-related filings under one heading, and will present more clearly those compensation events that are considered material.

The requirement for a dollar amount for the grant date values of stock options and performance-related awards is a welcome addition, but there are far better methods of presenting these awards, and these will be discussed later in this commentary.

Disclosing perquisites

There are a multitude of problems associated with the proposed disclosure of perks; and it is easy to see, immediately, how companies can and will circumvent the law to avoid proper disclosure. The proposals say: "We also propose that each item of compensation included in the All Other Compensation column that exceeds $10,000 be separately identified and quantified in a footnote." The "Request for Comment" asks:

- Should all compensation no matter how de minimis be required to be disclosed?

- Will companies be able to track this information without undue burden?

- Is $10,000 the appropriate threshold for separate identification and quantification?

The answers to these questions are: yes, yes and no, respectively. There is no real justification for any threshold, companies already track this expense, and there is very little likelihood that the information is not readily available. Therefore there should be no additional burden. Furthermore, the $10,000 threshold for separate identification is clearly open to abuse. Given that the threshold is being reduced because investors are interested in the "what", not necessarily the "how much", this lack of a requirement to identify separate perks is not even logical. Furthermore, it takes less than a nanosecond to figure out how to get around the rule. The only thing companies would need to is break perks down into tiny, less than $10,000 increments in order to evade disclosure. In this way, an executive could receive 10 separate, equally valued perks worth a total of $90,000 and not have to disclose any of them. Or, instead of disclosing a car allowance, the company breaks this down into a car leasing allowance, and a petrol allowance, and a car insurance allowance, and a chauffeur's uniform allowance, and a chauffeur's uniform cleaning allowance, and a car valet allowance, and a travel allowance per trip…. Pretty soon, you have all other compensation of $800,000, comprised of 800 separate items, none of which needs to be disclosed individually. Furthermore, with the proposed threshold, the absurd situation is still in place where a tax reimbursement on a perk has to be disclosed, but not the perk on which the tax is reimbursed. This clearly does not make sense.

The SEC is proposing that the incremental cost of perquisites and benefits be reported, not the 'taxable benefit'. This effectively addresses stockholders' other concern; that the cost of benefits be provided.

Summary Compensation Table should include only earned compensation
There are a number of supplementary tables to the Summary Compensation Table proposed under the new regulations. The first is a Grants of Performance-Based Awards Table. This first additional table would still be necessary even under The Corporate Library's suggested new structure for the Summary Compensation Tables (see below).

A Grants of All Other Equity Awards Table is also proposed by the SEC. This is equivalent to the current Stock Option Awards Table. In other words, it is proposed that there will be a performance equity awards table and an "all other" equity awards table. Again, this table would also be necessary under The Corporate Library's proposals. This "all other" equity awards table is where companies will have to record regular, market-based stock options, as well as time-vested stock and other non-performance related awards. It is interesting to note this implicit admission from the SEC that market-based stock options are not inherently performance-based – an admission that has received scant attention as yet.

The Corporate Library's suggested changes
As far as the Summary Compensation Table is concerned, it would seem that the best way forward would be to have two such tables: one that indicates monies received in the year; and the other that discloses the target, future level of compensation aimed at by present grants and awards. In order to achieve this level of homogeneity, both the value

of any restricted stock grant and the number of stock options awarded should be removed from the current and proposed Summary Compensation Table. The value of any restricted stock that has vested in the year should be included in the ‘earned compensation’ table – a very different value from the ‘grant date value’ of the total award. In the ‘future compensation’ table, the amortized annual value of any present restricted stock grant should be included. This has the added advantage of obviating the distortions to pay levels that occur because of the boom and bust effect of irregular stock grants.

The two tables would therefore include the following items for each named executive officer. All amounts are dollar amounts:

“Earned Compensation”: Compensation received in fiscal year	**“Future Compensation”: Target compensation**
Base salary	Base salary rate (the rate set during the year, not the amount paid)
Cost of perquisites and other benefits received (itemized in supplemental table)	Expected cost of perquisites and other benefits received (itemized in supplemental table)
Annual bonus	Target annual bonus
Value of any vested restricted stock	Value of any restricted stock award amortized over the vesting period
Value of any exercised stock options	Grant date value of stock options
Value of any other LTIP payout	Target payout of any other LTIP
All other compensation (itemized in supplemental table)	Expected cost of all other compensation (itemized in supplemental table)
Total compensation	Total target compensation

In this way, all the ‘apples’ will be in one table, and all the ‘oranges’ will be in another. Even under the current arrangements, the summary compensation table is a mix of apples and oranges.

At the very least, the SEC’s proposed Summary Compensation Table should include only those “earned” items outlined in the first of these suggested tables.

Outstanding equity awards

Also proposed by the SEC is an outstanding equity awards table, which will combine the current table giving the number of vested and unvested stock options with the note outlining the number and value of restricted stock awards for each named officer, and will add in any unvested performance shares or units and their value. The final column for this: Incentive Plans: Market or payout value of nonvested shares, units or other rights held. And it is only this final figure, in column six, that presents any difficulty, because the value of any performance awards cannot be determined until the performance has been determined. One solution would be to adopt a target valuation, with an explanation of the criteria used included in a footnote.

A further table is proposed by the SEC that would outline option exercises and stock vesting. The Corporate Library suggests that the dollar amounts proposed for this table be included in a reframed Summary Compensation Table. Nevertheless, it is important to know the number of options exercised and the number of shares that vest, so a table disclosing this is still necessary. More important still, given the ostensible reason for awarding equity, would be to include a column indicating how many shares had actually been retained. Such disclosures might make it a little more uncomfortable for executives to exercise and sell equity awards, and would also bring kudos to those executives that exercised and retained equity.

Post-employment compensation

In an attempt to improve disclosure of what are fast becoming the most controversial elements of executive compensation – pensions and severance packages – the SEC proposals are calling for full disclosure of each of these items.

The first of these, pensions, will be dealt with in two tables. The first table will be called Retirement Plan Potential Annual Payments and Benefits. The case for including early retirement details does not seem completely convincing, but more information is always better than less. Of far more interest, however, would be a discounted lump sum cost for the pension. This should be made available whether this is an option that executives can opt for under the terms of the plan or not. Stockholders are primarily interested in the cost of providing such benefits, and while an annual retirement benefit figure will indicate the level of cost to a certain extent, a lump sum amount is far more useful for such purposes. Other matters in a narrative description to follow the table are also very welcome, particularly disclosures surrounding company policies with regard to granting extra years of credited service.

Not specified here – and, again, potentially of more interest to stockholders who have to pay for these benefits – are potential funding details. Are plans funded or unfunded? If they are unfunded, what provisions have been made for future funding? These are the questions that stockholders would like answered.

The second table deals with non-qualified deferred compensation (NQDC), another area that has received scant disclosure but great interest. Footnote disclosures will indicate the extent to which amounts in these columns have or have not been disclosed already in the Summary Compensation Table. But, it would seem much simpler, and again of more interest, to indicate what proportion of the aggregate balance was actually deferred by the executive and what proportion has accrued as a match, or in interest, or in some other way. If a CEO, for example, receives a payout of around $140 million from a NQDC account that has been 95 percent funded from deferrals of compensation already reported, this is unlikely to provoke much response from stockholders. If only 55 percent had been deferred, already reported pay, and the rest was additional, clearly non-performance-related compensation, a different level of response can be expected. In any case, it is these proportions that are of most interest. This requirement would also allay any fears of ‘double counting’ because it would be very plain what had already been counted.

Disclosing golden parachutes
SEC proposals call for severance benefits to be disclosed in a narrative, requiring that companies give the estimated payments and benefits that would be provided in each termination circumstance. It is very important that disclosure covers each termination circumstance; we already have an example of a company – Morgan Stanley – volunteering such information, but selectively, so, when a termination actually occurred, its cost bore no relation to anything that had been disclosed. At the same time, the current $100,000 disclosure threshold with respect to post-termination perquisites is being eliminated, with the same disclosures being required as apply to current perquisites. The SEC's proposed narrative disclosure is unlikely to improve matters to the fullest extent possible, however, as it would be far more effective to have these disclosures in tabular form. More significantly, there are already examples of companies very clearly indicating the range of potential severance benefits in tabular format (see El Paso's Corporation's proxy statement for an example). Where figures are involved, it is an invariable rule that a tabular format is both easier to understand and easier to present, and should be adopted for every such disclosure.

No specific reference is made to the valuation of equity on termination, an aspect of severance too important to ignore. Again, there exist good examples of how to go about valuing the compensation that will arise from the immediate vesting or otherwise of equity (again, see El Paso Corporation's proxy statement).

Whose compensation is disclosed?
Under the current arrangements, only the CEO's compensation is mandatorily required to be included in the Summary Compensation Table. All other officers' compensation is included only if they earn a total annual salary in excess of $100,000. These disclosure rules are being revised so that the chief financial officer's compensation will also have to be included in the table, along with that of up to three others, but only if they earn total compensation in excess of $100,000. There is a long and, to be honest, entirely unnecessary discussion as to how to define these other named officers. None of this would be an issue if the SEC simply followed what is general practice in Europe, where compensation for all officers and directors is required to be disclosed. This has been a requirement in the U.K. since the mid 1990s, and in many countries in continental Europe since the late 1990s and does not appear to have occasioned the downfall of any economies, so there can be no serious arguments against it.

At last, proper disclosure of director compensation
The decision by the SEC to require companies to present a summary compensation table for directors is long overdue. Ignoring the fact that, as ever, most of continental Europe has been presenting this information for some considerable time – often for more than one board – even foreign filers providing the minimum level of compensation information that is required in a Form 20-F have had to disclose the total cost of the board. Some U.S. companies had already begun to provide this table – Aetna and Pfizer are examples.

This amount of information is most welcome; indeed the final column – all other compensation – will, for most companies, be made up of entirely new disclosures. Few of the amounts intended to be in this column are currently available, except for the consulting fees, and then only if they are in excess of the current threshold of $60,000. In addition, unvested equity awards will be disclosed. For some reason, it is proposed that this be a footnote disclosure, rather than a tabular one as has been proposed for executive officers. Again, tabular disclosure is far more appropriate for figures than is narrative or footnote disclosure.

It is, however, to be hoped that the narrative discussion of director pay structures is retained, as stockholders will still be interested in actual fee levels, committee membership retainers and meeting attendance fees.

While any improvement on current director compensation disclosure provisions is appreciated, and the proposed structure is certainly an improvement, there are still further improvements that could be made. For example, for the same reason that it would be more representative of actual compensation to give vested and/or exercised stock award values for executives, it would be more representative for directors. That is not to say that the dollar value of restricted stock or stock unit awards and stock option awards should not be provided, it is as important a disclosure for directors as it is for officers, but the table that describes current, earned compensation should include only that. In other words, if directors have exercised stock options, or if restricted stock has vested during the year, then that is what should be included, not the future value of awards; those should be in another table estimating future payouts.

Compensation for non-directors/non-officers

The SEC also proposed an additional disclosure for up to three employees who were not executive officers but whose total compensation for the last completed fiscal year was greater than that of any of the named executive officers. This would require disclosure of the amount of each such employee's total compensation for the most recent fiscal year and their job position. No further disclosures are proposed. Nevertheless, there is likely to be fierce opposition from issuers to this requirement, which has long been sought by stockholders. While further details beyond a total compensation figure are not required, it should be obvious to companies that if they have to disclose compensation for employees that is in excess of that for the most highly-paid officers, it is likely to be very high compensation indeed, and in such a case it would behoove the company to indicate, at the very least, what proportion was paid as incentive pay, and what performance merited it.

Compensation Discussion & Analysis

SEC proposals also suggest that the compensation committee report and the performance graph will be eliminated, to be replaced by a new compensation discussion & analysis (CD&A) similar to the management discussion & analysis filed with companies' annual reports. The intent behind this is to replace the report – which the SEC judges to have become meaningless boilerplate – with a more honest and detailed discussion of compensation philosophy and policy. The elimination of the performance graph is also an improvement. This performance graph has largely ceased to provide any meaningful addition to the compensation report, even, in many cases, not being placed anywhere near the report within the proxy statement. Furthermore, in the vast majority of cases, companies neither compare their performance, nor their compensation levels, to the group used in the performance graph. For this reason, the graph has no bearing or influence on compensation decisions at the company. If there are to be graphs, it would be of far more use to include graphs that:

- show the company's performance using the performance metric it uses for its incentive plans, and;
- compare that performance to the peer group it actually uses.

This would be a useful addition to the canon of disclosures.

Many, though not quite all, compensation committee reports do not vary from year to year; in some cases compensation committee reports do not vary from company to company. Many, though not all, are boilerplate, so few will be sorry to see them go. But only if they are replaced with something that is more meaningful and contains more disclosures, as well as being in plain English. If the CD&A has not answered the questions: who, why, what, where, when and how, then it has not done its job.

The list of disclosures suggested for this principles-based requirement include a number of items not previously considered for disclosure, such as how the compensation committee made the determination as to when an equity award was granted. There are also a number of items that are commonly given scant attention by compensation committees, such as what caused increases or decreases in compensation. Added to these, at the very least, should be some indication of the consideration of internal equity, in other words, relative pay levels within the company. If this does not take the form of a comparison between executive officer compensation and median compensation levels for non-officer employees of the company, it should at least discuss how the compensation committee has considered the issue of internal equity, and what relationship the named executive officer compensation levels have with those of the next highest tier of management.

The most important issue that needs a significant improvement in disclosure is the description of specific items of corporate performance that are taken into account when determining incentive awards. Unfortunately, the proposed regulations say this:

> …companies are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any factors or criteria involving confidential commercial or business information, the disclosure of which would have an adverse effect on the company….

They do go on to say that the standard that should be used for this is the same standard that is used when companies request confidential treatment of trade secrets and commercial or financial information in other filings – a standard that is clearly not being used at present. While it is obvious that companies would not wish to disclose confidential financial targets at the beginning of a fiscal year – though this rule does not seem to apply to earnings guidance – there can be no good reason for those targets to remain confidential after the end of that fiscal year. More importantly, the achievements – also rarely disclosed here – have already been published in the company's annual report, so it would appear particularly obstructive for companies not to repeat such information in the CD&A.

The problem with this continued, potential loophole is that the former loophole has led to a situation whereby the following is true of companies in the S&P 500:

- 15 percent of companies give no information on performance metrics;
- 60 percent provide a non-specific statement that they consider EPS, net income, or whatever the metric is when deciding on the level of bonus payout;
- 20 percent indicate that they consider EPS, net income, or some other named metric, and that EPS was $0.X per share. They also sometimes list other achievements, but do not indicate how the actual result compared to the target;
- 4.5 percent indicate that they consider EPS, or some other named metric, and it was $0.X per share, and represented an XX% growth over the prior year;
- 0.5 percent indicate that the target was EPS, and the level set for target achievement was $0.X per share, but achievement was $0.X + 1 per share, therefore bonus paid out at XX% of target.

The latter two bullet points should be the minimum level of disclosure, not the maximum. If companies can tell Wall Street what their targets are every quarter, it is difficult to understand why they cannot tell their stockholders once a year what they were and whether management was held to them. The proposed regulations should be much more specific about the expectations in this area, or companies will simply stick with the meaningless boilerplate disclosures that are currently used.

Filed, not furnished

Finally, the regulations propose that the CD&A would be soliciting material and would be filed with the commission. Additionally, the CD&A and other compensation disclosures would be covered by the certifications that the CEO and the CFO are required to make under the Sarbanes-Oxley Act. It might be countered here that the CEO and the CFO are not responsible for the report or the decisions made therein, and that the board is, and should be, the entity certifying, or at least signing off on them. Nevertheless, the SEC's position is the most effective one legally. There is no reason why, even though they did not make the decisions or write the report, the CEO and the CFO should not be responsible for ensuring that what appears is a true, accurate and complete record of what has, is and could be paid out as compensation, and that the policies and decisions described are those that actually happened.

While having this data filed and not furnished is certainly an improvement in accountability, it is an inadequate step when compared to the U.K.'s decision to have the compensation committee report subject to stockholder approval at each annual meeting. If the SEC's intention is to ensure that the board and the compensation committee are properly focused, then such a vote would be the perfect discipline. And the decision to remove the requirement that the names of the compensation committee members be appended to any compensation discussion is, frankly, immaterial. The proxy discloses who the members were, so stockholders know who was responsible, and that is clearly what is most important.

The proposals describe the reason for the decision to move from furnishing a report to filing a report thus:

> In adopting the current rules in 1992, the Commission took into account comments that the Compensation Committee Report should be furnished rather than filed to allow for a more open and robust discussion in the reports. Little that we see in current Compensation Committee Reports suggests that this treatment has resulted in such discussions, or at least the more transparent disclosure that the comments suggested would result. Further, we believe that it is appropriate for companies to take responsibility for disclosure involving board matters as with other disclosure.

This situation – the SEC making the right decision in the first place and then being persuaded against its better judgment to water requirements down – happened too often in 1992. This was also the case with the threshold for perquisites – an obvious flashpoint – and with the director summary compensation table.

The conclusion? Stick to your guns.

Paul Hodgson, Senior Research Associate, 3/10/2006