

# COUNCIL OF INSTITUTIONAL INVESTORS

Suite 500 • 888 17<sup>th</sup> Street, NW • Washington, DC 20006 • (202) 822-0800 • Fax (202) 822-0801 • [www.cii.org](http://www.cii.org)

Via Email

January 25, 2007

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

*Re: Executive Compensation Disclosure (File Number: S7-03-06)*

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of 140 public, corporate and union pension funds with combined assets of over \$3 trillion (“Council”). The Council appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC” or “Commission”) interim final rules adopting amendments to the disclosure requirements for executive and director compensation (“Amended Rules”). We, however, must express our disappointment that our comments and the comments of other investors cannot have any practical impact on the Amended Rules applicable to the 2007 proxy statement disclosures because the Amended Rules became effective on December 29, 2006.<sup>1</sup>

We note that the effective date for the Amended Rules was the same date the rules first appeared in the Federal Register, and thirty-one days before the comment period will close.<sup>2</sup> Absent extraordinary circumstances, we believe investors should be provided a meaningful opportunity to comment on significant changes to SEC rules and regulations *before* those changes become effective. The ability for investors to have an opportunity to comment is particularly important when, as discussed further below: (1) investors publicly supported the requirements in the original rule that are now amended; (2) investors did not request the amendments; and (3) the Amended Rules indicate that the Commission has concluded that the amendments will benefit investors.<sup>3</sup>

We acknowledge and appreciate that the Amended Rules require companies to report the full grant fair value of stock and option awards in the year of the grant in a new column added to the Grants of Plan-Based Awards Table.<sup>4</sup> We, however, continue to support the original rule that would have required companies to report the grant date fair value amounts in the more prominent Summary Compensation Table.<sup>5</sup> The basis for our continuing support of the original rule is set forth in our March 2006 comment letter in response to the SEC’s January 2006 proposed rule.<sup>6</sup> Our comment letter states:

The summary compensation table is an important tool used by investors to gain a “snapshot” of total compensation paid during the year. The Council generally supports the SEC’s proposals regarding the table—particularly the disclosure of the total compensation figure and the full present valuation of stock option awards . . .

. . . [T]he Summary Compensation Table should disclose the decisions of the compensation committee in the applicable year. Most of the information presented in the proposed columns is consistent with this perspective, including the disclosure of the grant date full fair value for equity instruments, which the Council strongly supports.

<sup>1</sup> Executive Compensation Disclosure, Release Nos. 33-8765; 34-55009 (Dec. 29, 2006) [71 FR 78338, 78339] (“Amended Rules”).

<sup>2</sup> Id.

<sup>3</sup> Id. at 78340-41.

<sup>4</sup> Id. at 78342.

<sup>5</sup> Executive Compensation and Related Disclosure: Final Rule and Proposed Rule, Release Nos. 33-8732A; 34-54302A; IC-27444A (Sept. 8, 2006) [71 FR 53158, 53171-72] (“Original Rule”).

<sup>6</sup> Letter from Ann Yerger, Executive Director, Council of Institutional Investors, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 29, 2006).

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One of the most important (and long overdue) reforms contained in the proposal is the requirement that companies disclose the full grant date present value of equity instruments. The SEC's proposed approach is appropriate, meaningful, consistent with other disclosures and readily understandable to investors. The Council would oppose eliminating the proposed requirement or weakening it to permit the disclosure of an alternative valuation, such as the amounts expensed under FAS 123R. The proposed methodology is consistent with the objective of providing investors with the tools needed to evaluate the annual decisions of the compensation committee, and it should be retained in the final rule.<sup>7</sup>

The Council has been, and continues to be, a strong proponent of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (revised 2004) ("Statement 123R").<sup>8</sup> Statement 123R, however, is an accounting standard intended to provide for the appropriate reporting of the cost of employee services received in exchange for an award of equity in a company's statement of earnings.<sup>9</sup> Consistent with the reporting of most other forms of compensation in earnings statements, Statement 123R requires that the share-based compensation cost be recognized over the periods during which the employee performs the related services.<sup>10</sup>

In contrast, the original rule's requirements for the Summary Compensation Table were intended to provide for the appropriate reporting of the amount of stock and option awards to certain executives during the reporting period.<sup>11</sup> Consistent with the timing of proxy disclosure of option awards since 1992, the original rule would have required the reporting of the full grant date fair value of the stock and option awards *in the year* of the award.<sup>12</sup>

The original rule acknowledged that the Statement 123R recognition of compensation expense was inconsistent with the purpose of stock and option awards disclosure in the Summary Compensation Table.<sup>13</sup> The original rule explains:

Disclosing these awards as they are expensed for financial statement reporting purposes would not mirror the timing of disclosure of non-equity incentive plan compensation. While we have imported a financial statement reporting principle to enable disclosure of compensation costs, executive compensation disclosure *must continue to inform investors of current actions regarding plan awards – a function that would not be fulfilled applying financial reporting recognition timing*. If a company does not believe that the full grant date fair value reflects compensation earned, awarded or paid during a fiscal year, it can provide appropriate explanatory disclosure in the accompanying narrative section.<sup>14</sup>

The Amended Rules offer the following two arguments in support of the Commission's "surprise move"<sup>15</sup> to reverse the requirements in the original rule: (1) the new requirements "will better fulfill the Commission's objective of informing investors of current actions regarding plan awards . . . ;"<sup>16</sup> and (2) the new requirements "will be easier for companies to prepare and investors to understand."<sup>17</sup>

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<sup>7</sup> Id. at 4-5 app.

<sup>8</sup> See Council of Institutional Investors, 2005 Annual Report 9 (Jan. 2006).

<sup>9</sup> See Statement of Financial Accounting Standards No. 123, ¶ B32 (revised Dec. 2004).

<sup>10</sup> Id. ¶ B144.

<sup>11</sup> See Original Rule, 71 FR at 53170.

<sup>12</sup> Id. at 53172 (The Original Rule explaining, "[t]he only change [since 1992] is that the awards are now disclosed in dollars rather than number of units or shares").

<sup>13</sup> Id.

<sup>14</sup> Id. (emphasis added).

<sup>15</sup> David B.H. Martin & David H. Engvall, Covington & Burling LLP, SEC Amends Disclosure Rules for Stock-Based Compensation, Securities Client Advisory, Dec. 28, 2006, at 1.

<sup>16</sup> Amended Rules, 71 FR at 78341.

<sup>17</sup> Id.

With respect to the first argument, as indicated above, we believe, and the SEC initially agreed, that the Commission's objective of informing investors of current actions regarding plan awards is best served by the original rule's requirement that companies report the full grant date fair value of executive compensation awards in the Summary Compensation Table. We note that the Amended Rules reference over two dozen investor or investor-based organizations that submitted comment letters generally expressing support for that view.<sup>18</sup> As acknowledged in the Amended Rules, those organizations generally agreed that requiring companies to report the full grant date fair value in the fiscal year of the award in the Summary Compensation Table, "would provide a more complete representation of compensation and would be more consistent with the purpose of executive compensation disclosure."<sup>19</sup>

We also note that the Amended Rules reference eleven organizations that submitted comment letters expressing support for the view taken in the Amended Rules that the Summary Compensation Table should report, "the proportionate amount of an award's total fair value that is recognized in the company's financial statements for the fiscal year."<sup>20</sup> Those eleven organizations include the American Institute of Certified Public Accountants and the Chamber of Commerce of the United States of America, but do not appear to include *a single investor or investor-based organization*.<sup>21</sup>

With respect to the second argument, we believe it is questionable whether the new requirements will make the Summary Compensation Table easier for companies to prepare and investors to understand. The Amended Rules suggest that such benefits will result, at least in part, from aligning the amounts required to be reported in the Summary Compensation Table with the amounts required to be reported by Statement 123R in a company's earnings statement.<sup>22</sup> An analysis by a prominent law firm, however, concludes that the reversal introduces "greater complexity to the rules . . ."<sup>23</sup> The greater complexity arises, at least in part, because the Amended Rules significantly depart from the Statement 123R requirements by disregarding estimates of forfeitures when computing amounts to be shown in the Summary Compensation Table.<sup>24</sup>

Finally, we note that one implication of the Amended Rules is that the amount for stock and option awards reported in the Summary Compensation Table will generally be less than the aggregate grant date fair value of such awards that would have otherwise been required to be reported under the original rules.<sup>25</sup> Moreover, it appears that the companies that will receive the greatest benefit from the reversal are the more than 800 companies, many in the high technology industry, which accelerated the vesting of employee stock options prior to the adoption of Statement 123R.<sup>26</sup> It has been estimated that those companies "dodged" the reporting of more than \$4.7 billion in after tax compensation costs in their earnings statements.<sup>27</sup> Those companies will again avoid the reporting of some portion of those costs in the Summary Compensation Table. In commenting on the practice of accelerated vesting of employee stock options prior to the adoption of Statement 123R, a prominent accounting analyst opined:

Weren't options supposed to "align management interests with those of the shareholders?" That link is broken with accelerated vestings just as surely as it is broken with backdated stock options. . . . And it's an insult added to injury when the supposedly "worthless" options become intrinsically valuable and employee recipients are no longer required to provide services. Some alignment!<sup>28</sup>

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<sup>18</sup> Id. at 78339 n.13.

<sup>19</sup> Id. at 78339.

<sup>20</sup> Id. at 78339-40.

<sup>21</sup> Id. at 78340 n.14. We also note that the Securities and Exchange Commission's then Deputy Chief Accountant, Scott Taub, appeared to acknowledge that the Amended Rules would not result in better information than the Original Rules when he stated: "'I don't think one answer or the other necessarily provides more complete or fuller disclosure—they're just two different ways of providing the information . . .'" C.E. Rosen, The SEC Stirs the Pot on Executive Comp, CFO.Com, Jan. 4, 2007, at 2 of 3.

<sup>22</sup> See Amended Rules, 71 FR at 78340.

<sup>23</sup> Jeremy L. Goldstein & David E. Kahan, Wachtell, Lipton, Rosen & Katz, SEC Changes Approach to Valuing Equity Awards under Compensation Disclosure Rules, Jan. 3, 2007, at 1.

<sup>24</sup> See David B.H. Martin & David H. Engvall, at 2; Jeremy L. Goldstein & David E. Kahan, at 2.

<sup>25</sup> David B.H. Martin & David H. Engvall, at 4-5.

<sup>26</sup> See Jack T. Ciesielski, The Analyst's Accounting Observer, Aug. 15, 2006, at 2.

<sup>27</sup> Id.

<sup>28</sup> Id. at 3.

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We appreciate the opportunity to comment on the Amended Rules. Despite the concerns referenced above, we continue to strongly support the Commission's ongoing efforts to update and improve executive compensation disclosures.

Sincerely,

A handwritten signature in cursive script that reads "Jeff Mahoney". The signature is written in black ink and is positioned to the left of the typed name.

Jeff Mahoney  
General Counsel