Watson Wyatt
Worldwide

May 26, 2009

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Subject: Request for Rulemaking to Amend Item 402 of Regulations S-K to revise the Current Summary Compensation Table to Better Depict the Compensation Earned for the Year by Named Executive Officers

Dear Chairperson Schapiro:

We are writing to request that the Commission reconsider the current Summary Compensation Table (SCT) disclosures for depicting the annual compensation of named executive officers on company proxies. From recent press reports (*SEC Chair Says Regulatory Agency Considering Changes to CEO Pay Disclosure Rules*, by Rachel Beck, Associated Press Business Writer, April 30, 2009), we understand the Commission is interested in revisiting the depiction of stock-based compensation on the SCT in a manner that more accurately states the actual value earned by executives for the year. The press account suggests the change being contemplated is to show the fair value of grants made for the year rather than the cost recorded on the financial statement for the year.

We applaud the Commission for seeking to improve the current rules so that shareholders will have a better understanding of the compensation earned by executives for the proxy year. However, we would urge the Commission to consider taking a different approach that would more accurately reflect the value earned by the executive for the year rather than the pay opportunity being granted for the year. We have attached a copy of an article we recently authored that outlines our suggested approach, which focuses on depicting the *pay realizable* by an executive during the year. We believe this approach accurately depicts what the executive actually earned (or lost) in stock value during the year, and would be an extremely valuable change for shareholders seeking clarity on this issue. We also have provided a link to the article as posted at our website:
http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=21017

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We are hopeful the Commission will seriously consider adopting the approach we suggest in the article. We are available to discuss this matter with you, the Commission or the Commission Staff, at your convenience.

Best regards,

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Attachments:

1. *Improving Executive Compensation Disclosure: Why the SEC Rules Don't Fit in a Down Market,* Watson Wyatt Insider, April 2009, Volume 19, Number 4, page 15.

Improving Executive Compensation Disclosure: Why the SEC Rules Don't Fit in a Down Market

By Ira T. Kay and Steve Seelig

Changes to the executive compensation disclosure rules made during Christopher Cox's tenure as chairman of the Securities and Exchange Commission (SEC) vastly improved disclosures, particularly in the enhanced Compensation Discussion and Analysis (CD&A) section. However, in reviewing the 2008 stock price performance for our clients, we have found the reporting rules require these companies to significantly overstate the value of executive compensation earned. The overstatement will make the inevitable criticism of executive pay practices that arises each proxy season far worse than it should be. In an effort to blunt the critics, companies might shift from shareholder-friendly equity compensation programs to less effective cash-based programs.

Proxy disclosures should not drive compensation plan design, and this article suggests changes new SEC Chairwoman Mary Shapiro could make to create more transparent and informative disclosures.

Source of the problem

The past year has been tumultuous for shareholders and corporate executives alike. Annual bonuses are no longer paying out at target or maximum. Much of the value has been wiped out of long-term cash incentives measured at 2008 year end, most executives' stock options are underwater and time-based restricted stock is yielding far less value than anticipated. Broadly speaking, these outcomes demonstrate that the U.S. compensation model works – executives are not rewarded unless they deliver the desired financial results.

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Because the SEC disclosure rules generally require companies to disclose a *fixed* value calculated at the start of the year (or earlier), later drops in stock value are not reflected in disclosed total compensation amounts. This misleads shareholders into believing executives are being paid far more than they are.

The discrepancy between executives' reported and received earnings arises from two SEC policies:

1. Requiring a single number to depict total annual compensation
2. Using existing accounting rules under Statement of Financial Accounting Standards (FAS) 123(R) to value stock compensation

The SEC should consider putting all elements of compensation on the same disclosure footing.

With the best of intentions, the SEC wanted to give shareholders a single number so they could easily compare payments to their named executive officers (NEOs) with those to their industry peers. But disclosure experts believe the combined effect of these two policies has been to create "apples to oranges" comparisons. Simply stated, cash compensation is shown in real time based on the value *earned at year end;* stock grants are shown based on the value *estimated at the start of the year or earlier.* This discrepancy in valuation approach and timing is at odds with the notion that all compensation can be viewed as fungible.

Corporate America tolerated this approach for the 2007 and 2008 proxy seasons, while stock values continued to climb. In those years, proxy disclosures tended to understate compensation values because executives' earnings were higher than grant date values. The 2009 proxies, on the other hand, will greatly overstate the value of executives' earnings during the year.

Using a simple baseball analogy, let's say one person gives another a pair of tickets in February to see the Washington Nationals play a game in September. Today, the face value of two tickets is $100. Yet when September rolls around and the fan can't make the game and needs to sell the tickets, their value might be very different. The Nationals might be mired in last place and playing another also-ran, so selling the tickets might be tough at any price. Or it could be a crucial game that will determine the division winner for that season, in which case the seller might be able to name his price. There are two ways to value the tickets: They are still worth $100 or they are worth whatever the market will pay on game day.

The SEC's approach looks at the tickets' face value and ignores their game-day value. And in a year when most companies' stock values have tumbled, executives are holding tickets for a game between two also-rans. Given that many executives are getting little in the way of cash bonuses this year, the reaction has leaned toward revamping existing programs to put far less equity at risk. We think that direction is a bad idea for corporate America and is at odds with the way companies should "pay for performance."

The solution

The SEC should strongly consider putting all elements of compensation on the same disclosure footing. In considering this proposal, it is important to distinguish between the concepts of *pay opportunity* and *pay realizable*. Using the baseball ticket analogy above, the face value of the tickets is the *pay opportunity*. It measures the value of the tickets at a given point in time but does not reflect their ultimate value. For a stock option grant, which provides value to the recipient only if the stock price increases, the *pay opportunity* is the FAS 123(R) value, most often calculated using the Black-Scholes method.

To make matters more confusing, the FAS 123(R) value that appears in the proxy's Summary Compensation Table (SCT) is not the value of equity *granted* for the year. Instead, this number may include unvested options granted many years earlier, because all unvested equity is

lumped together to determine the FAS 123(R) value for the year. So the SCT number does not even accurately reflect the executive's *pay opportunity* for the year. Much of the popular press recognizes this as problematic. Rather than using the total compensation number that appears in the SCT, both The Wall Street Journal and the Associated Press (whose stories disproportionately appear in local newspapers interested in what chief executive officers in their area earn) substitute the FAS 123(R) value of equity granted during the year for the FAS 123(R) equity value depicted on the company's financial statement.

These SCT numbers do not reflect the value of the executive's earnings. Returning to the baseball ticket analogy, the proper number is the market value of the tickets on game day. For stock options, that would be the in-the-money value as of year end. For restricted stock, restricted stock units and performance shares, that would be the end-of-the-year stock price. We call this number the *pay realizable*. It reflects the total value of all equity that would be available to the executive, if monetized, plus the value of all cash compensation. Stated differently, this is the year-end value of all compensation the executive earned that year, including compensation that was not monetized via a stock option exercise.

Using this *pay realizable* concept enables companies and compensation committees to determine whether their compensation program truly pays for performance. Proxy disclosures would say how much equity value executives earned or lost during the year, and shareholders could easily determine whether pay reflects those results. More important, shareholders could compare the pay realizable for their executives with that at peer organizations. This would enable them to ascertain whether pay levels were linked to the company's performance when compared with the median earnings of its peers. Making this comparison is equally important during prosperous and down years. This helps facilitate the central tenet of the SEC disclosure rules: Shareholders should have enough information at their disposal to determine whether executive pay is commensurate with corporate performance.

How would it work?

The following example illustrates how the SEC rules should measure total compensation for the year. Figure 1 shows the current SCT approach for a CEO who received both restricted stock grants and stock options during the year.

Assume all equity grants have a three-year graded vesting schedule and the company granted $1 million in option value and $1 million in restricted stock value for each of the past three years. Further assume the company's stock value rose from $30 at the start of 2006 to $40 in 2007 and to $50 in 2008, but it had dropped to $20 by year-end 2008.

The *pay realizable* approach would far more accurately depict executive compensation.

Because current rules show columns (e) and (f) based on the FAS 123(R) value for the year, the executive appears to have earned $2 million in 2008, even though at year end, the stock awards are worth only $522,220 and the stock options are all underwater with no in-the-money value.

Figure 2 illustrates the *pay realizable* approach, which accurately reflects the value of the executive's earnings or losses during the year. Executives would no longer be depicted as having earned far more than they did in a down market but far less than they earned in an up market. The approach places the value of stock grants and long-term cash programs on an equal footing with salary, bonuses and long-term cash incentives earned or paid for the year. It tells shareholders exactly what their executives earned that year, which will become especially important if "say-on-pay" becomes a reality.

How to measure pay realizable

The overarching idea of *pay realizable* is similar to that of the change in pension value in column (h) of the current SCT. That is, the value earned based on the change in value from one year to the next of unvested equity grants is the amount recorded. However, because lower equity values represent a real economic loss for executives who have not yet earned or cannot yet monetize their equity holdings, *pay realizable* could be a negative number. As mentioned earlier, allowing for a negative number clearly conveys that compensation programs pay for performance but not for failure.

The *pay realizable* approach would change only two columns in the SCT but would far more accurately depict executive compensation:

Figure 1 | Current Summary Compensation Table treatment

Name and principal position	Year	Salary ($)	Bonus ($)	Stock awards ($)	Option awards ($)	Non-equity incentive plan compensation ($)	Change in pension value and NQDC earnings ($)	All other compensation ($)	Total ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
CEO	2008	$1,000,000	$200,000	$1,000,000	$1,000,000	$250,000	$250,000	$50,000	$3,750,000

Source: Watson Wyatt Worldwide.

Compensation opportunity

Figure 2 | Proposed Summary Compensation Table treatment

Name and principal position	Year	Salary ($)	Bonus ($)	Stock awards realizable ($)	Option awards realizable ($)	Non-equity incentive plan compensation ($)	Change in pension value and NQDC earnings ($)	All other compensation ($)	Total ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
CEO	2008	$1,000,000	$200,000	($783,330)	($1,222,220)	$250,000	$250,000	$50,000	($255,550)

Source: Watson Wyatt Worldwide.

Compensation realizable

1. **Stock awards realizable – column (e).** Rather than the FAS 123(R) value, this column would show the annual change in the value of equity being expensed under FAS 123(R) of the following pay elements:

   a. *Unvested restricted stock, restricted stock units, performance shares and performance units.* To figure out the value earned or lost from unvested equity under current rules, shareholders must obtain the unvested grant information from the Grants of Plan-Based Awards and Outstanding Equity Awards at Fiscal Year End tables and then perform independent calculations. So most shareholders remain unaware of the true year-end value of equity gains or losses. Under our suggested approach, one component of the change in equity value recorded in column (e) would reflect that of equity that remained unvested during the year.

   b. *Restricted stock, restricted stock units, performance shares and performance units vested during the year.* Under current rules, the value realized is disclosed on the Option Exercises and Stock Vested table, but the change in value from the prior year is not. Shareholders can calculate the total value of pay realized from equity vested during the year, but this value will reflect earlier compensation gains or losses and does not associate earnings or losses with the proper year. Under our suggested approach, for equity that vested that year, we would determine the change in value from the start of the year to the vesting date based only on the equity for which the company recorded an accounting expense, and record it in column (e).

In the above example, to determine the change in equity value for the year, we would consider the $1,305,550 in unvested restricted stock at the start of the year, which declined to $522,220 as of year end, resulting in a loss of $783,330. Figure 3 illustrates how the calculation is done.

2. **Option awards realizable – column (f).** This column would include the change in value from the prior year of the following pay elements:

   a. *Outstanding unvested stock options.* This would apply to the change to the in-the-money value of outstanding unvested options – the amount the executive can monetize when the options vest. As with restricted stock and restricted stock units, shareholders must find information about option grants from the Grants of Plan-Based Awards and Outstanding Equity Awards at Fiscal Year End tables and then calculate the value earned or lost from unvested equity. The change in the in-the-money value of these unvested options would be recorded in column (f) and would

Figure 3 | Determination of change in equity value

	1/1/2006	12/31/2006	1/1/2007	12/31/2007	1/1/2008	12/31/2008	Totals
Stock price	$30	$40	$40	$50	$50	$20	
# of shares granted	33,333		25,000		20,000		
# of shares expensed in 2008	11,111		8,333		6,667		
Start of 2008 value ($50) for # of shares expensed	$555,550		$416,667		$333,333		$1,305,550
End of 2008 value ($20) for # of shares expensed	$222,220		$166,667		$133,333		$522,220
2008 change in value for # of shares expensed	($333,330)		($250,000)		($200,000)		($783,330)

Source: Watson Wyatt Worldwide.

reflect equity that remained unvested during the year. Similarly, the change in the in-the-money value of options that vest during the year would be recorded from the start of the year until the vesting date.

b. *Exercised stock options.* We would not recommend reporting the total in-the-money (intrinsic) value realized at exercise as described on the Option Exercises and Stock Vested table in column (f). While some consider this the true value of annual compensation, we believe this value reflects option grants for a number of earlier years based on volitional actions by the executives and thus would not reflect pay decisions made by the board in the most recent proxy years.

In the above example, to determine the change in equity value for the year, we would consider the $1,222,220 in unvested stock options at the start of the year, which declined to $0 as of year end, resulting in a loss of $1,222,220. Figure 4 illustrates the calculation.

What can companies do now?

We understand the Obama administration and the SEC have a lot on their plates this year, and revamping the proxy disclosure rules might not be at the top of their agenda. But executive compensation has been a lightning rod for political attacks, and attempts at regulation are likely in the near future. Companies should use their proxy and CD&A to demonstrate that their programs are paying less for lower performance, and should use a calculation of *pay realizable* to demonstrate where executives have lost significant compensation value for the year. Many of our clients have taken this approach, and their CD&As make a far more cogent argument that their compensation programs are properly calibrated in times of high and low achievement.

Stated more bluntly, companies that fail to demonstrate that their programs pay for performance may be in for more trouble down the road from pay critics and the press, especially if Congress decides to mandate “say on pay” for future proxy years. ■

Figure 4 | Determination of change in option value

	1/1/2006	12/31/2006	1/1/2007	12/31/2007	1/1/2008	12/31/2008	Totals
Stock price	$30	$40	$40	$50	$50	$20	
# options granted	133,333		100,000		80,000		
# options expensed in 2008	44,444		33,333		26,667		
Start of 2008 intrinsic value for # of shares expensed	$888,887		$333,333		$0		$1,222,220
End of 2008 intrinsic value for # of options expensed	$0		$0		$0		$0
2008 change in value for # of options expensed	($888,887)		($333,333)		$0		($1,222,220)

Source: Watson Wyatt Worldwide.