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National Association of Stock Plan Professionals

<u>**Via Electronic Mail**</u>

August 18, 2009

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proxy Disclosure and Solicitation Enhancements Proposing Release
File No. S7-13-09

Dear Ms. Murphy:

We are pleased to submit this letter in response to Release No. 33-9052. The following suggestions are being submitted relatively early in the comment process to enable the SEC Staff and the Commission to implement—in time for this upcoming proxy season—important changes identified and set forth primarily in the "Other Requests for Comments" section of the Proposing Release at pages 63-65 (pages 35092-3 of the Federal Register version). These suggestions, which address weaknesses in the current disclosure requirements, are particularly timely—and important to implement now—in order to restore integrity to the proxy disclosures and public trust in the disclosures.

Addressing Short-Sighted Risk Taking and Identifying Incentives That Create Long-Term Enterprise Value—Importance of a Hold-Through-Retirement Disclosure

The new proposals regarding risk disclosure in the CD&A appear to many practitioners as not providing enough specific guidance to be meaningful. As a result, there is great risk that most companies' disclosures will fail to address specific, important action items.

A prime example is the need for companies to focus on the encouragement of short-term risk taking (to increase the stock price) that is inherent in most stock option and restricted stock grants. A key disclosure point for shareholders is whether compensation is geared toward short-term gains or long-term value for shareholders.

The final rule should clearly specify that the CD&A includes a discussion that requires the compensation committee to address equity compensation, and the presence or absence of a long-term holding provision for the CEO and top level executives. It is generally recognized now that a hold-through-retirement component is an important provision to address the short-term risk taking vs. long-term value creation concern—and to show shareholders that executives receiving equity grants will focus on long-term enterprise value. (See the July-August 2009 issue of *The Corporate Executive* at pgs 7-8 and see the November-December 2008 issue of *The Corporate Executive* at pg 1.)

This also applies to large bonuses (and whether a meaningful portion of such bonuses is paid in equity that must be held for the long term). By having a captioned disclosure addressing hold-through-retirement and other long-term provisions such as clawbacks for bonuses based on short-term actions/results that had adverse long-term consequences, shareholders will be able to assess whether a board's compensation practices are fostering a short-sighted risk taking mentality or a "skin in the game" long-term value approach.

Lastly, it should not be overlooked that the hold-through-retirement disclosure requirement should also apply to directors to guard against the same short-sighted risks that can influence executives' decisions. For example, if it is disclosed that a director is required to hold a significant portion of his/her equity grants for the long term, shareholders will be able to ascertain that the directors are focused on ensuring long-term value creation.

Internal Pay Equity—Important Disclosure and Analysis

One significant criticism of the way many boards set executive compensation centers around benchmarking against survey results in order "to be competitive." External comparisons are only one component. Compensation committees must also take into account the impact on employees and other stakeholders where the CEO's compensation has gotten out of line from the company's own historical internal ratios. Over the last 20 years, due largely to increased equity compensation grants and large post-employment provisions, CEO compensation at many companies has gotten out of line from the company's own historic norm. This disparity, in turn, results in lower employee morale and a lack of shareholder trust in management and boards.

The "to be competitive" mantra is not analysis. It is akin to companies that engaged in risky derivative or mortgage transactions justifying their actions by saying "everyone else is doing it and we need to be competitive." Directors must now be held accountable to analyze—and then address—compensation practices that are no longer appropriate. Internal pay equity analysis is a key internal analysis to counter external survey chasing. Internal pay equity analyses can ferret out where and to what extent equity grants were transformed into another form of annual compensation (as opposed to a long-term incentive), and how severance and other post employment "safety net" provisions were implemented without appropriate sunsetting once a CEO's accumulated wealth has reached a point where there is no longer a need for a safety net.

We strongly support the need for a CD&A section addressing internal pay equity analysis. The disclosure should not only provide the findings, but also include a critical *analysis* of the corrective actions considered and implemented. This disclosure will provide shareholders with the kind of information and analysis that is necessary in order to assess a company's compensation policies—and the compensation committee's performance.

To prevent the numbers from being gamed, the analysis must include all components of compensation, including all equity grants and the full walkaway amounts the CEO will receive. Also, to prevent a company from "gaming the ratios" by raising the compensation of the next level of executives, the comparisons should be against several different levels of executives, as well as to the average worker. And, the comparisons should go back historically within the company.

The Need for CD&A Disclosures of Key Analytic Tools Utilized by the Compensation Committee—Including the Resulting Findings and Analysis—and Corrective Actions Considered and Taken

In order for shareholders to be able to assess the performance of directors on the compensation committee and to make an intelligent decision on a say-on-pay vote, it is critical to see the analysis that went into the compensation committee's decisions—and to see whether the compensation committee employed generally accepted analytic tools—and for shareholders to gain insight into the resulting findings and analysis, and corrective actions considered and taken by the directors on the compensation committee.

It is not enough to simply state in the CD&A that the compensation committee considered tally sheets and other tools. The CD&A should specifically address the key tools: tally sheets, internal pay equity analysis and full walkaway/wealth accumulation analysis. Just as with internal pay equity, the CD&A must provide shareholders with the findings, the compensation committee's analysis and corrective actions considered and taken.

The Compensation Committee Report and the CD&A—Accountability

A fundamental problem with CD&A disclosures and analysis has been the question of ownership and accountability for the disclosures. Unfortunately, without clear accountability on the part of the directors on the compensation committee for the content and actions set forth in the CD&A, directors have not scrutinized the disclosures—and particularly the lack of real analysis—in the same way they would if they felt true personal responsibility for the disclosures and knew they would have potential exposure for material misstatements or omissions. As a result, for example, directors are not pressing for the inclusion of meaningful analysis in the CD&A in the same way they would if they were held accountable for these material disclosure omissions.

Shareholders who are trying to ascertain whether to vote for the election of directors—particularly, those on the compensation committee—(and who also will be casting say-on-pay votes) are entitled to know what analysis and actions the directors took. Yet, notwithstanding a multitude of Staff comment letters and various speeches from the Staff, the CD&A (which was hailed by the Staff and the Commission as the cornerstone of the 2006 proxy disclosure amendments) has not lived up to expectations. This is largely due to the accountability gap.

By making the CD&A part of the Compensation Committee Report and requiring that the Report be "filed," we believe that the current flaw in accountability will be rectified—and that shareholders will receive the kind of analysis that the CD&A was intended to provide.

Knowing that your signature is under the CD&A and that your name is "on the line" makes a difference. We expect that some who might want to shield their director clients from responsibility might argue that, since most CD&As are drafted by in-house HR personnel or company counsel, directors should not be accountable. Indeed, this situation has led to a "no accountability zone" where the drafters feel that they are only scribes and the directors are assuming that what the drafters have written complies with the requirements (and thus they can sign off in the current compensation committee report). The way to address this lack of "ownership" is not to say keep it the way it is, but to make the CD&A the Compensation Committee's disclosure.

[Also, the argument that not being "filed' encourages more fulsome disclosure has been proven wrong by the lack of meaningful analysis in CD&As, notwithstanding Staff admonitions at Conferences and in Staff comment letters. Accountability is the key to compliance.]

Drafter Accountability. Although some drafters may claim to be only "scribes," drafters decide on the initial content (and analysis—or lack thereof) and often serve as advisers regarding what is "required" and what should be disclosed/addressed and what the analysis should look like. Some drafters and reviewers have intentionally muddied the CD&A disclosures. Drafters truly are gatekeepers, with attendant responsibility and accountability. An important fix that would place responsibility on those drafting the disclosures—in addition to the directors on the Compensation Committee—would be to add a requirement that the names of the individuals who were the principal drafters of the CD&A be listed under a heading Principal CD&A Drafters in a company filing (*e.g.*, the 10-K).

Ensuring Independence. We believe that such a "name on the line" accountability requirement would serve as an important, effective component of the "independence" requirements being proposed for directors and consultants because having your name on the line would address the inherent conflict faced by anyone who advises directors or executives who feels compelled to sugar coat the guidance for fear of jeopardizing the relationship with the client/employer.

Providing Full Walkaway Numbers

One of the most important proxy disclosure fixes that needs to be in place for this upcoming proxy season can be accomplished without a new rule change. It involves ending a misleading practice that has enabled most drafters and compensation committees to ignore (or intentionally avoid) their principles-based obligation to provide full walkaway numbers in proxy statements and to avoid any attendant analysis. As Treasury Secretary Geithner underscored in his June 10 statement on executive compensation that was coordinated with the SEC, providing the walkaway number is essential in order to analyze the need for—and to assess the compensation committee's justification for—maintaining severance and SERPs and other post-employment "safety nets."

The omission of full walkaway numbers has resulted in misleading disclosures that are only uncovered after the fact when an executive is terminated or leaves the company and the full walkaway amounts are finally disclosed (or ferreted out).

A clear statement in the adopting release that principles-based disclosure requires providing full walkaway numbers and the attendant analysis of the need for safety net provisions where the accumulated amounts may have obviated any need, could suffice for now. For the sake of clarity, however, we believe that in addition to a clear statement from the Staff, there will need to be a specific disclosure requirement in the rule at some point (ideally now) so that drafters and advisers don't use the current dodge of getting around principles-based disclosures by pointing to the rules and saying: "where does it say that in the rules?"

162(m)—Another Key Fix to Address Non-Compliance—That Can Be Accomplished Right Now

The Emergency Economic Stabilization Act of 2008 (the "EESA") and the US Treasury's Capital Purchase Program (the "CPP") has brought the SEC's Section 162(m) disclosure guidance to the forefront again, with a requirement that any participating institution agree, as a condition to participate in the CPP, that it will be subject to the $500,000 annual deduction limit under Section 162(m)(5). Section 162(m)(5), which was added by Section 302 of the EESA, reduces the deduction threshold for the remuneration paid to senior executive officers during any taxable year from $1 million to

$500,000, and it also eliminates the exception to the deduction limit for "performance-based compensation" as well as deferred compensation.

A major disclosure gap has arisen now. A financial institution subject to the $500,000 deductibility limit imposed in the EESA that chooses, nevertheless, to pay more, may (incorrectly) conclude that it does not have to disclose this fact in its proxy statement. The Section 162(m) compliance disclosures provided by participating financial institutions in their proxy statements this past year underscore the problem. Companies are not providing to shareholders the actual amounts paid to NEOs in excess of the caps, disclosing the lost tax deductions or explaining how those amounts—as well as the public's expectations of compliance—have been considered in the compensation committee's analysis and decisions.

We believe that this information is material for all companies, especially given the current economic climate and needs to be disclosed in the CD&A; otherwise, shareholders will have no idea if the boards of their companies are sticking with the applicable restrictions or purposefully exceeding them (at shareholders' additional expense through lost tax deductions). The SEC should make clear that principles-based disclosure requires actual disclosure of any amounts received by each executive that exceeded the deductibility cap, the amount of the foregone tax deduction and an explanation and conclusion that the board considered the issue and nevertheless decided to exceed the deductibility limits. This disclosure requirement should also specify that issuers must make clear that the forgone tax deduction is a real cost to the issuer.

Just as with providing full walk-away numbers and analysis, this disclosure (and tax gross-up disclosure) can be accomplished (even without a specific new rule) by a clear statement from the Staff or the Commission that principles-based disclosure requires providing this material information.

Additional Important Fixes

We also direct the Commission's attention to the fixes enumerated in the attached March-April 2009 Special Supplement to *The Corporate Executive,* and the comments set forth in the attached July-August 2009 issue of *The Corporate Executive,* which we would like to make a part of our comment.

Key Supporting References

Lastly, in further support of the need for having the above changes in place for this year's upcoming proxy statements, we direct the Commission's attention to:

1. The attached Summer 2009 issue of *Proxy Disclosure Updates,* in which former Chief Counsel, David Lynn, and former Special Counsel, Mark Borges, assess the past year's proxy disclosures and conclude on page 13:

   What We Did Not See

   Unfortunately, many disclosures did not contain the critical analysis that the SEC has made clear should be provided in the CD&A. Too often, an explanation of "to be competitive" took the place of real analysis. When use of tally sheets and wealth accumulation and internal pay equity analyses were mentioned, generally there was little or no accompanying discussion of how they were used, the findings or any resultant actions. Also, it is troublesome that many companies still are not providing the actual amounts paid to the CEO and other NEOs in excess of the Section 162(m) deduction limit.

Further, companies seem to be ignoring (or intentionally avoiding) the need to provide full "walkaway" numbers upon a termination of employment, making the retirement and severance estimates provided in disclosures incomplete and misleading. When shareholders (and compensation committees) do not receive the full walkaway amounts (including accumulated unrealized equity gains and accelerated vesting, etc.), public trust is eroded and "principles-based" disclosure is undermined.

Each of us involved in the process—from those advising boards of directors to those who draft and review the disclosures, to institutional shareholders and regulators—must do our part to address these shortcomings and help restore trust and integrity to the system.

2. The Summer 2009 issue of *Compensation Standards,* which focuses on the Administration's four guiding executive compensation principles and addresses the need (at pgs 4-5) for full walkaway disclosure and other relevant disclosures.

If you have any questions with respect to the above or require additional amplification or clarification, please feel free to contact the undersigned at 925.685.5111.

Respectfully,

Jesse M. Brill

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National Association of Stock Plan Professionals

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Attachments

cc: Hon. Mary L. Schapiro, Chairman
Hon. Kathleen L. Casey, Commissioner
Hon. Elisse B. Walter, Commissioner
Hon. Luis A. Aguilar, Commissioner
Hon. Troy A. Paredes, Commissioner
Meredith Cross, Director, Division of Corporation Finance
Brian Breheny, Deputy Director, Division of Corporation Finance
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Paula Dubberly, Associate Director, Division of Corporation Finance
Anne Krauskopf, Senior Special Counsel, Division of Corporation Finance
N. Sean Harrison, Special Counsel, Division of Corporation Finance

Attachment A

March-April 2009 Special Supplement to *The Corporate Executive*

THE CORPORATE EXECUTIVE

PUBLISHER: JESSE M. BRILL P.O. Box 3895, San Francisco, CA 94119

THE NEWSLETTER FOR THOSE THAT ADVISE PUBLIC COMPANIES

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Now is the Time to Revisit the Executive Compensation Disclosure Rules

Our Critical Fixes for the SEC

While it seems difficult to believe, the SEC's 2006 revisions to the executive compensation disclosure rules took place in a very different time. At the time of the SEC's rule amendments, few anticipated the sweeping financial crisis and the effect that the crisis and the economic downturn has had on the public's perception of executive compensation. SEC Chairman Schapiro recently announced in a speech to the Council of Institutional Investors that the Commission is considering proposed new rules relating to compensation. The proposed rules would focus on ensuring that shareholders fully understand how compensation structures and practices drive an executive's risk taking. Further, the Commission will consider whether greater disclosure is needed about a company's overall compensation approach—beyond decisions with respect to the highest paid officers—as well as enhanced disclosure about compensation consultant conflicts of interest.

In these times when trust in the system has been eroded, it is important that shareholders, issuers, executives and their advisors see that the SEC is doing its part to restore trust in the disclosures that are fundamental to the system. In this connection, it is perhaps even more important that the SEC not focus exclusively on the executive compensation disclosure issues outlined above; rather, the SEC should also focus on those key fixes that need to be made now so that the compensation disclosure rules can fully achieve their intended purpose. It is truly unfortunate that despite all of the public statements from the Staff and the guidance and comment letters that have been issued, the SEC has not been able to get what was hailed as "the cornerstone" of the 2006 changes—the CD&A—on track as a meaningful source of *Analysis* for investors. Now is the time for the SEC to address the problems head on, so that issuers and their advisors have an unmistakable picture of the SEC's expectations—and so that the public receives the analysis and disclosures that were intended. It would be a shame if the SEC were to forgo this opportunity to restore public trust in the disclosures.

We have made several of these suggestions before (see the Special Supplement to the March-April 2008 issue of *The Corporate Executive*), but we think that these suggestions warrant repeating in light of the current environment. We think that the Staff should move quickly to make these changes and have them in place in advance of next year's proxy season.

Analysis in the CD&A

The SEC Staff's continuing response to the CD&A has been: "Where is the analysis?" Indeed, the bulk of the Staff's comments on the proxy statements over the last two years have focused on eliciting more analysis in the CD&A. The Staff's October 2007 Report indicated that many comments "asked companies to enhance their analyses of compensation policies and discussions, including how they determined the amounts of specific compensation elements." In seeking this information, the Staff's goal was to elicit discussions "of *how* they arrived at the particular levels and forms of compensation that they chose to award to their named executive officers and *why* they pay that compensation, giving investors an *analysis* of the results of their compensation decisions."

Specifically Require Analysis in the CD&A. A potential source of this weakness in the disclosures provided so far under the new executive compensation rules may have been the wording of the CD&A requirement itself. While Item 402(b) of Regulation S-K is labeled "Compensation Discussion and Analysis," the word "analysis" is used sparingly in the Item's explicit requirements, and there are few references to the specific analytic tools that companies are—or should be—using. For instance, Instruction 3 to Item 402(b) calls

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for a focus on the "principles underlying the registrant's executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions," but it does not actually call for the *analysis* itself. Further, the specific examples cited in Item 402(b)(2), while admittedly a non-exclusive list of material items to consider, only touch on (and in some cases obliquely refer to) the analytic tools that companies use—or should be using—when setting executive pay.

<u>An "Analysis" Caption.</u> In order to address these concerns, and to ensure that the intent of the rule is clear long after the current focus on the rule has waned, the SEC should require a separately captioned "Analysis" section of the CD&A. This separately captioned section will focus companies on the requirement to specifically discuss the key analytic tools, the findings from the analysis and how the findings were used in assessing and setting compensation. And, it would enable shareholders reading the CD&A to "find the beef." Within this separately captioned section would be separate analytical subsections for each pay element. The SEC has successfully used mandated captions to highlight particular types of disclosure—for example, Item 407 of Regulation S-K requires disclosure under the specific captions "Compensation Committee Report" and "Compensation Committee Interlocks and Insider Participation." Just as these specific captions focus attention on the particular disclosures (notably for not only shareholders and potential investors, but also for companies and their board committee members), a captioned "Analysis" section of the CD&A would highlight the lynchpin for the overall compensation picture, *i.e.,* the "why" that puts the rest of the disclosure into context. Without a separately captioned section, it is too easy for companies to pass off overly general assertions as their analysis, such as declaring that actions were taken for the most part to preserve the "competitiveness" of the compensation program. (See, *e.g.,* the Special Supplement to the January-February 2008 issue of *The Corporate Counsel*.)

<u>Highlighting the Analytic Tools.</u> In addition to adoption of a captioned section, Item 402(b)(1) of Regulation S-K should be revised to specifically call for disclosure about the analysis undertaken with respect to each of the other six elements that are already listed. Further, the 15 "suggestions" in Item 402(b)(2) need to be augmented with references to specific analytic tools. Currently, the Item specifically names perhaps the least effective analytic tool—benchmarking—which may have the unfortunate effect of putting too much emphasis on this already over-used approach. In order to fully identify the range of potential analytic tools, the list should also include specific references to whether the company has utilized tally sheets, a wealth accumulation analysis and/or an internal pay equity analysis, including how and why the particular analysis was used, the findings from the analysis and then what decisions were made and what compensation changes were considered/implemented and why. These key analytic tools—as often alluded to in the Staff's comments during its targeted review—should be specifically enumerated as potential topics for discussion in the CD&A.

Performance Target Disclosure

Under the current rules, companies may omit performance target measures in reliance either on a determination that the performance target levels were not (i) material, or (ii) based on a conclusion under Instruction 4 to Item 402(b) of Regulation S-K that the disclosure of these numbers would cause competitive harm. When performance target levels are omitted and adequate disclosure about the "degree of difficulty" in meeting those targets is not provided, investors are left without a clear picture of the link between pay and performance. As a result, compensation disclosures across companies are often not comparable, and perhaps the most critical information for understanding what motivates the named executive officers remains unclear. It seems that, to date, many companies have been willing to "take a chance" on the Staff questioning their non-disclosure decision in the course of a review.

<u>Mandatory Performance Target Level Disclosure.</u> Based on this experience, the SEC should recognize that its principles-based approach may not have adequately promoted fulsome disclosure of performance target measures. The required analysis in the CD&A is not possible when some of the most important data points are omitted on materiality or confidentiality grounds. The SEC should consider adopting an express requirement in the CD&A (and for the narrative disclosure accompanying the Summary Compensation Table under Item 402(e)) that mandates disclosure of performance target levels for completed periods, as well as a requirement to discuss current period or future period target levels, but only if material to an understanding of the disclosure and analysis about the company's compensation policies and decisions for the last completed fiscal year. The performance target disclosure should be required to be presented in tabular form.

Retaining a True Competitive Harm Standard. Given that there is still the potential for competitive harm from the release of sensitive information about target levels, the SEC could retain the current standard for omission when the target levels constitute confidential commercial or financial information. When the amendments were originally adopted in 2006, no new standard for confidential treatment was established; rather the SEC sought to rely on the familiar (and historically high) hurdle for omitting confidential information from filings under Securities Act Rule 406 and Exchange Act Rule 24b-2. This standard has not been the problem; the problem has arisen in applying the standard to a company's particular circumstances.

Therefore, the SEC does not need to change this well-established, pre-existing standard. However, instead of leaving it for investors, shareholders and the Staff to guess whether performance targets were omitted on confidentiality grounds, the SEC should require that the company include an affirmative statement in the disclosure that the specific target number was withheld based on a claim of confidential treatment (as is done today when confidential information is omitted from an exhibit under Rules 406 or 24b-2). The Staff should then seek to enforce the traditionally rigorous standard for confidential treatment through its comment process (after the fact), to ensure that target levels are not being inappropriately withheld. When target levels are withheld without an adequate basis under the confidential treatment standard, then the Staff should require an amendment to the filing to correct the information — just as it would if confidential treatment were denied for a portion of an exhibit today.

Finally, disclosure regarding how difficult it will be for the executive or how likely it will be for the company to achieve the target levels (as now contemplated in Instruction 4 to Item 402(b) when target measures are omitted) should be required in *all* circumstances, *i.e.,* when targets are disclosed or when targets are omitted. This disclosure should serve as a basis for the critical analysis of the target measures and their relationship to the named executive officer's or the company's performance. Investors have been asking for this disclosure in all circumstances, and by adopting it as an express requirement, the SEC will aid in facilitating an understanding of target measures and go a long way toward addressing the "where's the analysis?" problem discussed above.

Use of Discretion. With all of the recent focus on bonuses at financial institutions, the SEC should also consider expanding disclosure requirements directing companies to discuss the extent to which discretion can be utilized and was used in connection with making bonus decisions. This disclosure is all the more important in times when issuers are not meeting incentive targets and compensation committees are faced with determining whether and how to compensate executive officers. Given the "pay-for-performance" veneer of most executive compensation programs, it has become more critical to explain why bonuses are warranted—particularly when bonuses are preceded by layoffs or when rank-and-file bonuses have been scaled back or eliminated. Further, when issuers have layoffs, and bonuses are paid to NEOs, it is important for those issuers to analyze and disclose in the CD&A whether the bonus formula would have been met without the cost savings that resulted from the layoffs (as opposed to bonuses earned from real growth).

Presentation of Equity Awards in the Summary Compensation Table

Perhaps nothing has contributed more to the complexity—and confusion—regarding the new executive compensation disclosures as have the hastily adopted December 2006 amendments to the Summary Compensation Table and related disclosures, which mandated the presentation of the amounts expensed for equity awards instead of their grant date fair value. Had the SEC stuck with its original rules, many of the negative issues that plagued proxy statements over the past couple of proxy seasons (such as overly long and unduly complex CD&As, competing total compensation presentations in proxy statements and in press reports, lengthy discourses on the fine points of the recognition model of FAS 123(R), and negative total compensation numbers) could have been avoided.

Significant Complications. In today's down market, issuers are grappling with how vesting conditions in grants made in prior years impact the accounting for their equity awards and the resulting presentation in the Summary Compensation Table. While for service-based equity awards, compensation expense as shown in the Summary Compensation Table is essentially fixed, *i.e.,* the grant date fair value (disregarding any estimate for forfeiture) is spread out ratably over the service/vesting period, performance-based and "liability" equity awards can be subject to wide swings in the amounts reported year to year in the Summary Compensation Table. These swings can impact the named executive officers that are reported in the tables from year to year, and reversals or negative expense numbers arising from the accounting for these awards may cause negative numbers to be reported in the "Stock Awards," "Option Awards" and "Total Compensation" columns of the Summary Compensation Table. In the current climate, investors will be very confused upon finding negative compensation numbers in the Summary Compensation Table for named executive officers, which has the potential to inflict even more damage to the credibility of the compensation numbers.

Return to the Original Approach. It is not too late for the SEC to show that it "gets it" and to amend Item 402 to reflect the original approach of including the grant date fair value of equity awards in computing total compensation. The SEC seemed to acknowledge the problems with the current presentation when it announced the interactive Executive Compensation Reader—which permits the Summary Compensation Table to be "sliced and diced" so that total compensation can be computed using the grant date fair value of equity awards instead of the expensed portion of the awards. While this may be useful for investors of the small group of companies that are covered by the Reader, it does not change the impact that the expensing approach has had on the determination of named executive officers who show up in the table and how issuers have grappled with explaining the oftentimes anomalous results.

The issue here is not that one approach produces larger numbers than the other; rather it is that the total compensation number in the proxy statement that was going to bring uniformity and a "bottom line" approach to compensation disclosure has been rendered largely irrelevant, and that has compromised the ability of companies to provide the necessary level of clarity and analysis in the CD&A and elsewhere in the disclosure.

Alternative Presentations. If the Commission is not willing to adopt the pre-December 2006 approach for equity awards, then it could move to a more principles-based approach for presenting the Summary Compensation Table information. Instead of seeking to limit the manner of presentation of an "alternative" Summary Compensation Table, as was suggested in comment letters and the October 2007 Staff Report, the SEC could codify an approach that permits the use of some reasonable alternative presentation of the Summary Compensation Table information in situations where that alternative presentation is consistent with the way in which the compensation committee views and analyzes the information when making its compensation decisions. By taking this approach, the SEC could mandate the manner of presentation and the required information for an alternative table if it is elected, and could even retain the "expensing" table as the "default" approach in order to ensure comparability across companies and over time. Our clear preference, however, is to face the problem squarely and return to the original, pre-December 2006 approach.

Post-Termination Disclosure—The Necessity for Real "Walk-Away" Numbers

The 2006 amendments went a long way toward eliciting more disclosure about amounts payable under termination and change-in-control arrangements. Unfortunately, the amendments did not go far enough—more disclosure is not necessarily better when it is dense and unfocused. The way that the SEC can now address these concerns is through an approach that the Staff actually suggested to some companies through its targeted review comments, which would be to require total amounts for post-termination and change-in-control scenarios, rather than just presenting the incomplete "raw" data.

Require a "Walk-Away" Number. As was noted in our September-October 2007 issue and in the model CD&A disclosures provided in the January-February 2008 issue of *The Corporate Executive*, inclusion of total "walk-away" numbers provides the best means for avoiding "surprises" down the road in the event that the termination or change-in-control provisions are triggered. Companies have demonstrated that presenting these numbers can be done—Starbucks filed a proxy statement last year that included a table highlighting the total walk-away numbers (both with accelerated vesting of stock options and without accelerated vesting) upon termination or change-in-control scenarios. As companies and their compensation committees rethink the necessity of severance and other post-termination and change-in-control benefits, the need for disclosure of true walk-away values will increase, so that the analysis (or lack of analysis) underlying their decisions is transparent for shareholders.

The objective of presenting useful walk-away numbers cannot be achieved only through the suggestions from the Staff's comments seeking totals in the Item 402(j) disclosure. For the purposes of economy in presentation, the SEC did not require that the narrative or tabular disclosures of amounts payable upon termination or change-in-control scenarios include every element of compensation; instead, issuers may omit amounts payable under pension and non-qualified deferred compensation plans under Instruction 3 to Item 402(j) if those benefits are not enhanced or vesting is not accelerated. As a result, the currently required disclosure gives only a partial picture of the overall benefits, and insufficient data in one place to compute a full walk-away amount.

Moreover, the "static" analysis contemplated by the current Item 402(j) requirements (which assumes a triggering event happens at the end of the last fiscal year and at the end-of-year stock price) does not provide the complete walk-away picture. The SEC's disclosure requirements should track the analysis that compensation committees need to be undertaking, and include in the walk-away value not just unvested equity grants, but also previously exercised grants and projected future grants based on the assumption that they will be made on the same basis as the most recent award. Pension benefits should also be projected out as well in computing these walk-away numbers. (See, for example, the excellent model table provided jointly by Deloitte Consulting and Watson Wyatt set forth in the materials from the "5th Annual Executive Compensation Conference" available on CompensationStandards.com.) For the purposes of public disclosure, the SEC can specifically indicate that the safe harbor for forward looking statements is available for the projected walk-away amounts.

Standardization is Necessary. Without disclosure of the bottom line impact of post-termination and change-in-control provisions, the disclosure required by Item 402(j) has largely been unfocused and often confusing. In fact, the Item 402(j) disclosure has tended to be the second longest section of the compensation disclosure after the CD&A. While the principles-based approach of allowing companies to format this disclosure as they saw best was perhaps a noble effort, it is clear from the first two years of results that some level of standardization is necessary in order to make the disclosure useful. For the purpose of facilitating a presentation of the total walk-away amounts, an approach similar to the Summary Compensation Table should be adopted. In so doing, the SEC can still preserve some flexibility for companies in determining how best to present various termination or change-in-control scenarios, but it can mandate the specific elements of compensation that must be included—as well as the manner of presentation for those elements. Further, issuers should be required to disclose, in footnotes to the numbers, how the numbers are calculated, including relevant assumptions.

Enhanced CD&A Disclosure. Further, the SEC should amend Item 402(b)(2)(xi) to specifically require a complete analysis of the "why" behind the termination and change-in-control arrangements. Currently, the item requirement only addresses the basis for selecting particular events as triggering events, without directing companies to delve into the underlying rationale for the arrangement in the first place. In particular, the requirement should direct companies to address the overall consideration of a named executive officer's wealth accumulation when severance, retirement or change-in-control benefits are established or maintained. The resulting disclosure should include an adequate justification for severance, retirement and change-in-control provisions, particularly where a CEO may have already accumulated several lifetimes of "security" so that there is no longer a need for the safety net provided by these provisions. In order to ensure that the compensation committee considers the consequences (including costs) of such arrangements, the SEC should require a statement in the CD&A or in the Compensation Committee Report that the committee reviewed all of the elements and determined "all aspects of the program, including severance, were reasonable and necessary." And, the instruction should state clearly that saying "to be competitive" is not analysis. In these times, it has become very clear that justifying an action because "everyone else is doing it" does not satisfy one's fiduciary obligations to the company and to shareholders.

Requiring Risk Analysis Disclosure in the CD&A

In consideration of the Congressional mandate to financial institutions receiving TARP funds, companies are beginning to focus on risk, and its implications, in their CD&As. In the past few months, it has become clear that the Staff is expecting discussion of these matters by all companies, not just financial institutions. As John White, the former Director of the Division of Corporation Finance stated at our conference last year: "Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target—with risk, in this case, being viewed in the context of the enterprise as a whole?" In order to level the playing field for all companies, the SEC should revise the CD&A requirement to specifically mandate the sort of risk-based disclosure and compensation committee certification that is now expected of the institutions receiving TARP funds. A new disclosure mandate and annual certification will encourage issuers to consider the extent to which elements of pay packages encourage unnecessary and excessive risks, which will serve as an important backdrop for the overall analysis of compensation that needs to be described in the CD&A.

The Need for a Specific 162(m) Disclosure Requirement

When the SEC's specific mandate to address the applicability of Section 162(m) was omitted in favor of principles-based disclosure, it seems that in some cases companies just decided to drop the Section 162(m) disclosure entirely (presumably concluding that it was no longer material), and those that have retained it include mostly boilerplate disclosure. (Readers should be reminded that the SEC in the adopting release for the 2006 amendments stated that the new approach "should not be construed to eliminate this [162(m)] discussion" as well as other "tax consequences to the named executive officers as well as tax consequences to the company.")

The Emergency Economic Stabilization Act of 2008 (the "EESA") and the US Treasury's Capital Purchase Program (the "CPP") has brought the SEC's Section 162(m) disclosure guidance to the forefront again, with a requirement that any participating institution agree, as a condition to participate in the CPP, that it will be subject to the $500,000 annual deduction limit under Section 162(m)(5). Section 162(m)(5), which was added by Section 302 of the EESA, reduces the deduction threshold for the remuneration paid to senior executive officers during any taxable year from $1 million to $500,000, and it also eliminates the exception to the deduction limit for "performance-based compensation" as well as deferred compensation. Given the flexibility afforded by the SEC's CD&A requirement, however, a financial institution subject to the $500,000 deductibility limit imposed in the EESA that chooses, nevertheless, to pay more, may (incorrectly) conclude that it does not have to disclose this fact in its proxy statement. The Section 162(m) compliance disclosures provided by participating financial institutions in proxy statements filed so far this proxy season underscore the problem. Companies are not providing the actual amounts paid to NEOs in excess of the caps, disclosing the lost tax deductions or explaining how those amounts—as well as the public's expectations of compliance—have been considered in the compensation analysis and decisions.

We believe that this information is material for all companies, especially given the current economic climate and needs to be disclosed in the CD&A; otherwise, shareholders will have no idea if the boards of their companies are sticking with the applicable restrictions or purposefully exceeding them. The SEC should require a separate, captioned section in the CD&A addressing Section 162(m), which should require actual disclosure of any amounts received by each executive that exceeded the deductibility cap, the amount of the foregone tax deduction and an explanation and conclusion that the board considered the issue and nevertheless decided to exceed the deductibility limits. This disclosure requirement should also specify that issuers must make clear that the forgone deduction is a real cost to the issuer.

Required Disclosure Concerning Hedging and Pledging Transactions

The SEC should revise the CD&A requirements to specifically require disclosure of pledging transactions. Item 402(b)(2)(xiii) of Regulation S-K currently calls for, if material, a discussion in the CD&A of "the registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging of the economic risk of such ownership."

While the item only refers to hedging, the principles-based approach of CD&A suggests that other, related material policies and decisions, such as an executive's exposure to margin calls for pledged securities, and the adverse incentive consequences associated with that sort of event, should also be discussed. Unfortunately, in too many cases, companies may be reading this example too narrowly, and not providing a complete picture of the extent to which executives are permitted to hedge or pledge away a portion of their stock. Recent market swings have focused attention on the significant downside of the practice of pledging shares by executives of public companies.

As a result of the disparate treatment between hedging and pledging arrangements in the CD&A and the beneficial ownership table, investors often do not get a full picture of the extent to which the executive's economic interest may diverge from their own. These arrangements represent a real concern for investors, because when things go bad for the executive, it has an impact on the value of all investors' holdings, as the forced selling of large blocks of stock to satisfy a margin call or as a result of a hedging arrangement can drive down the market price of the stock. Perhaps even more important for the long term, even when times are good, hedging and pledging arrangements raise a fundamental question as to whether all of the equity awards that an executive has accumulated will continue to act as an incentive, particularly when those shares may very well be called away pursuant to the terms of a margin loan or when some of the economic consequences associated with holding the securities have been hedged away.

A Few More Items

Some other aspects of the rules may require further SEC attention. For example, now that restricted stock is playing a greater role in compensation, the SEC should consider the presentation of restricted stock dividends in the Summary Compensation Table, so that these potentially large, material amounts of compensation are disclosed. With respect to the Outstanding Equity Awards Table, the disclosure would provide much better context to the analysis in the CD&A if the SEC required disclosure of the unrealized appreciation amount for outstanding stock options as well as tabular disclosure augmenting that table, which would present the cumulative amounts realized by NEOs from equity compensation, including those amounts realized from prior exercises or vesting. (See the January-February 2006 issue of *The Corporate Counsel* at pg 7.) In the area of perquisites, the SEC should consider adopting specific principles/requirements for how to measure aggregate incremental cost (particularly for airplane usage) in order to avoid the potentially material inconsistencies (and misleading amounts) that have emerged in light of the newly required disclosure about incremental cost methodology. (See the May-June 2005 issue of *The Corporate Counsel* at pg 1 and the January-February 2006 issue at pg 7.) As for benchmarking disclosure in the CD&A, the Commission should require that issuers disclose the specific criteria used to select the peer group.

Lastly, we know that the Staff has received various suggestions for changes to the disclosure of consultant involvement in the compensation process. Whatever course the SEC takes, the key questions that need to be addressed are whether the consultants had in fact: (a) suggested a particular course taken by the company and the underlying analysis; (b) actively agreed with that course and the underlying analysis; (c) passively acceded to that course of action and the underlying analysis; or (d) disagreed with the course of action and analysis. We also suggest that the SEC require disclosure of fees received by a consultant when the consultant performs services for management and the compensation committee. These insights are necessary for a complete understanding of the reasons behind the compensation decisions and a full description of the *actual* consultant involvement.

Time to Act

Now is the time to implement these changes, while momentum toward executive compensation reform continues to build and investors, Congress and others remain focused on the need for clear and complete disclosure. Just as Treasury has an obligation to address the TARP tax-related provisions, the SEC needs to do its part with respect to key disclosure fixes.

For more regarding the above suggestions, readers are directed to the Fall 2008 and Winter 2009 issues of Borges and Lynn's *Proxy Disclosures Updates* (available on CompensationDisclosure.com), the Special Supplement to the January-February 2009 issue of *The Corporate Executive,* the Special Supplement to the March-April 2008 issue of *The Corporate Executive,* the Special Supplements to the January-February 2008 and September-October 2006 issues of *The Corporate Counsel*, and the January-February 2006 issue of *The Corporate Counsel*. Readers should also consult with the up-to-the-minute resources available on CompensationStandards.com, including Mark Borges' Proxy Disclosure blog.

—JMB

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Attachment B

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THE NEWSLETTER FOR THOSE THAT ADVISE PUBLIC COMPANIES

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The SEC Moves Forward with Executive Pay Proposals: Is It Enough?

A Word from the Publisher

We devote most of this issue to the SEC's recently proposed changes to the executive compensation disclosures. On pg 2, we examine the SEC's proposal that companies discuss, in the CD&A, how the company's compensation policies can affect its risks and management of those risks.

On pg 4, we discuss the SEC's proposal to return to disclosing equity awards in the Summary Compensation Table based on grant date fair value—a welcome relief for many of our readers. On pg 6, we look at the SEC's proposed disclosures relating to compensation consultants.

We have a number of thoughts on the SEC's proposals; we discuss the areas where the SEC is seeking comment and our thoughts on the proposals on pg 6. Moreover, we have included the full text of our comment letter to the SEC as a Special Supplement to this issue.

We conclude this issue with a look at how purchase limitations, often triggered in a down market, can impact P&L expense for ESPPs.

November Conferences

This issue is merely the tip of the iceberg when it comes to what our readers will need to know as they head into next year's proxy season. The "4th Annual Proxy Disclosure Conference" and the "6th Annual Executive Compensation Conference" in San Francisco in November will be absolute "musts" this year for anyone involved in the preparation of proxy disclosures or in designing executive compensation programs. See pg 11 of this issue (and the enclosed Conference Agenda) for the exciting line-up of speakers at these acclaimed Conferences.

Anyone attending either of the aforementioned Conferences will also want to stick around for the "17th Annual NASPP Conference." The practical guidance delivered at this Conference will be critical in our current uncertain economic climate.

—JMB

The SEC's Proposed Changes

The SEC has proposed changes to the executive compensation disclosure rules, seeking to expand the scope of the Compensation Discussion & Analysis (CD&A) disclosure requirement to solicit more information about the relationship between risk and compensation. Further, the SEC proposed to reverse its "December Surprise" and move back to the reporting of equity compensation awards in the Summary Compensation Table based on the grant date fair value of the award, as opposed to the current requirement to report the awards based on the amount expensed for the fiscal year in accordance with accounting principles. In addition to some broader corporate governance-oriented proposals, the SEC also proposed expanding disclosure about the role of compensation consultants—and the potential for conflicts of interest—through disclosure of fees.

Beyond these targeted proposals, the SEC solicits comment on other areas where the executive compensation rules could be changed. The proposed rules do not represent any significant rethinking of the requirements in light of the continued level of shareholder outrage over executive pay and don't address some of the lingering concerns with the 2006 revisions to the executive compensation disclosure rules. With comments due to the SEC in the very near future, it appears likely that, at a minimum, the proposed new rules for the CD&A and disclosure of equity awards in the Summary Compensation Table will be in place for next proxy season. It is critical that boards and their advisors act now in order to be prepared for these and other significant changes that appear to be on track for the 2010 proxy season.

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The Relationship of Compensation and Risk

The SEC's compensation disclosure rule proposals do not take place in a vacuum. In a June 10, 2009 statement announcing broad principles for pay reform, Treasury Secretary Timothy Geithner specifically identified executive compensation practices as a factor contributing to the financial crisis. Among the broad principles for pay reform identified by the Treasury Secretary (acting after consulting with SEC Chairman Mary Schapiro, Federal Reserve Governor Daniel Tarullo and a group of experts) were calls for a new "pay for performance" paradigm, structuring compensation to account for timing of risks, the alignment of compensation practices with sound risk management, and reexamining post-employment compensation and SERPs. (For an analysis of the Obama Administration's compensation principles, see our Summer 2009 issue of *Compensation Standards* at pg 2.) The SEC, in taking its own actions regarding executive pay, did not delve into all of these principles as they are reflected in the SEC's disclosure rules. Rather, the SEC chose to focus on the principles relating to the relationship between compensation (including compensation beyond the executive suite) and risk, and did not go further to propose rule changes revisiting areas that remain in need of attention, such as the disclosure and analysis of true "walk-away" amounts for post-employment compensation arrangements.

A Broader Scope to the CD&A (But Only When Material)

The principal focus of the rule proposals is on how a company's overall compensation policies may impact its risk profile. Since the enactment of Section 111 of the Emergency Economic Stabilization Act of 2008, there has been a spotlight on the relationship of compensation to risk, first at financial institutions, and then as applied to the broader realm of all public companies. In particular, the concern has been the extent to which compensation polices might result in creating incentives that cause executives (and others) to take unnecessary and excessive risks that potentially threaten the value of an organization. At our "3rd Annual Proxy Disclosure Conference," John White, former Director of the Division of Corporation Finance, asked the question: "Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target—with risk, in this case, being viewed in the context of the enterprise as a whole?" With these remarks, John White provided the first glimpse at how the SEC would view the relationship of risk with compensation policies and practices (see our November-December 2008 issue at pg 2), culminating in the recent rule proposals.

Interpreting the Current Rules Regarding Risk. Despite John White's statement and other indications of the level of interest that this topic engendered at the SEC and with investors, disclosure addressing the risk issue was not widespread (or, when present, was not fully developed) in CD&As during 2009. [For an analysis of some of the disclosures that were provided, see the Summer 2009 issue of *Proxy Disclosure Updates* at pg 7. For a model risk disclosure under the principles-based standards of the current rules, see the Winter 2009 issue of *Proxy Disclosure Updates* at pg 1.] This is likely to change for the 2010 proxy season, even if the current rule proposals are not effective by that time, given that the SEC made it clear in the proposing release that "[t]o the extent that such risk considerations are a material aspect of the company's compensation policies or decisions for named executive officers, the company is required to discuss them as part of the CD&A under the current rules."

A Materiality Threshold. Under the proposed amendments to the CD&A disclosure requirement, a company would need to discuss, when material, how the company's compensation policies, as a whole, can affect the company's risk and its management of risk. The SEC and its Staff have emphasized repeatedly that these proposals are not seeking additional disclosure when it is not needed; rather, the proposed rules would seek the disclosure when the risks arising from the compensation policies and overall compensation practices for employees "may have a material effect" on the company. While this materiality qualifier appears intended to limit the frequency with which the disclosure is required, it is hard to imagine the circumstances in which a company could conclude that a cash incentive compensation program or an equity compensation program does not have the potential to create some risks that may have a material adverse effect on the company. In this regard, "pay for performance" in its very nature contemplates some level of risk-taking for most companies, given that employees will rarely be in a position to achieve real performance goals without creating some level of risk. In this way, it appears that the disclosure will be relatively universal (with the exception of companies that have limited incentive plans or have otherwise mitigated the risks), notwithstanding the materiality qualifier contemplated by the SEC.

Expanding the Scope of the CD&A. Today, CD&A is limited to discussion and analysis of a company's compensation policies and decisions regarding the named executive officers, and the CD&A is to relate specifically to the information disclosed in the compensation tables and otherwise disclosed pursuant to Item 402 of Regulation S-K. Under the SEC's proposals, the CD&A would potentially include discussion of company policies and decisions with respect to the compensation of named executive officers, other executive officers and non-executive officer employees. The proposals do not contemplate expanding all of the CD&A requirements to this larger group; rather, the policies and practices with respect to non-named executive officer employees would only need to be discussed in the context of how they relate to risk management practices and/or risk-taking incentives. However, in order to properly address the risk considerations, it may be necessary under the principles-based standards of the CD&A requirement to fully describe the relevant compensation policies and practices with respect to the non-named executive officer employees, so that the risk management and risk-taking elements may be put into proper perspective. Given these potential changes, companies will need to be prepared to publicly disclose a much wider range of compensation policies, programs and practices if these rules are ultimately adopted as proposed.

No New Tables Required. The proposed rule changes do not contemplate any additional disclosure about the compensation paid to employees in the organization as a whole; rather, the CD&A disclosure (if triggered) would focus strictly on policies and practices without getting into specific compensation levels for employees other than the named executive officers disclosed in the tables. In so doing, the SEC chose not to revive the so-called "Katie Couric" proposal to seek disclosure of the compensation paid to employees that exceeded the compensation paid to the highest paid executive officers, nor did it come up with an approach for reporting aggregate levels of compensation for covered employees. However, lacking specific compensation data, it may be difficult for investors to put the additional CD&A disclosure into perspective. As a result, it may be necessary for companies to provide some sort of relative quantitative disclosure about the compensation paid to a particular class of employees (*e.g.,* employees of a particular business unit) when discussing and analyzing the risk created by the applicable compensation policies and practices.

Triggering Circumstances for a Risk Discussion. The SEC's proposed changes to what is required in the CD&A do not spell out the types of risks that are contemplated. Companies (and their boards and compensation committees) will need to take steps to analyze all of the risks that may be created as a result of broadly-applicable compensation practices, and identify how those risks are considered and addressed. As contemplated by the proposal, the discussion of the relationship between compensation and risk may be required when, for example, compensation policies and practices involve:

- a business unit that carries a significant portion of the company's risk profile;
- a business unit with a significantly different compensation structure as compared to other units within the company;
- a business unit that is significantly more profitable than other business units within the company;
- a business unit where the compensation expense is a significant percentage of the business unit's revenues; or
- characteristics that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon the accomplishment of a particular task, while the income and risk to the company from the task extend over a much longer time period.

These potential triggering circumstances are by no means exclusive, and are designed to simply highlight the sort of circumstances that companies should be considering when examining the potential risks arising from compensation policies and practices. [*A Heads-Up.* For example, companies will want to focus on the encouragement of short-term risk taking inherent in stock options and restricted stock—and will need to address hold-through-retirement provisions in their CD&A disclosure. (See the important discussion in the Summer 2009 issue of *Compensation Standards* at pg 4.)]

Principles for Disclosure. Similar to other aspects of the CD&A requirement, the proposed rule changes would not mandate specific disclosure that must be provided, but rather provide examples of issues that the company may need to address when talking about the relationship between compensation and risk with respect to the business unit or group of employees being discussed. For example, the proposed rule would note disclosure about the general design philosophy regarding compensation policies for employees whose behavior would be most affected by contemplated incentives as these policies relate to risk-taking, and the manner of implementation of this philosophy.

Further, a company may need to address the company's assessment of risk or incentive considerations (if any) when structuring compensation policies or when making awards or paying compensation, as well as the extent to which compensation policies relate to realization of risks resulting from employee actions in the short-term and long-term (for example, through clawback or holding period policies—see our November-December 2008 issue of *The Corporate Executive*).

The rule would also note the possibility for a discussion of the company's policies regarding adjustments to compensation policies or practices necessary to address changes in the company's risk profile, and the extent to which the company monitors compensation policies in order to determine whether the company's risk management objectives are being met with respect to employee incentives.

This proposed CD&A disclosure will be put into context by a broader disclosure requirement under the proposed rules that would require a company to describe the level of involvement of the board of directors in the risk management process, and the effect that the board's involvement has on the company's leadership structure. This new disclosure (which would be outside of the executive compensation disclosure) would need to include, for example, a discussion of how the board implements and manages the risk management function, whether those who oversee risk management report directly to the full board or to a committee of the board, and how the board (or the relevant board committee) monitors risk.

Where's the Analysis? As we have noted before (see our March-April 2009 Special Supplement of *The Corporate Executive* at pg 1), while Item 402(b) of Regulation S-K is labeled "Compensation Discussion and Analysis," the word "analysis" is used sparingly in the Item's explicit requirements. So too would be the case for the proposed new disclosure regarding risk, which as proposed would specifically require a company to "*discuss* the registrant's policies or practices of compensating its employees, including non-executive officers, as they relate to risk management practices and/or risk-taking incentives." While the proposed new paragraph goes on to make it clear that the purpose is to "provide investors material information concerning *how* the registrant compensates and incentivizes its employees that may create risk," it does not go on to call for the all-important "why" and specifically the analysis that the compensation committee has conducted in the course of examining the relevant approach and the attendant risk. Given the frustrating experience that the Staff had with implementing the CD&A requirement over the past few years, it may be appropriate for the SEC to make the proposed rule as clear as possible as to the need for analysis in this and all other parts of the CD&A.

Revisiting Equity Award Disclosure—Some Welcome Relief

The SEC's proposals would thankfully amend the reporting of stock and option awards in the Summary Compensation Table and the Director Compensation Table, by going back to the way the rules were originally adopted in the summer of 2006. As we noted in our March-April 2009 *Special Supplement* at pg 3, perhaps no other change contributed more to the complexity—and confusion—regarding the new executive compensation disclosures than the December 2006 amendments to the Summary Compensation Table and related disclosures that mandated presentation of the amounts expensed for equity awards instead of their grant date fair value. [In proposing this change, the SEC noted the discussion in the March-April 2009 issue of *The Corporate Counsel* (at pg 3).]

The Best Approach for Equity Awards? Under the proposed changes, the SEC would require disclosure in the Stock Awards and Option Awards columns of the fair value of equity awards on the grant date, as opposed to the current disclosure requirement that is based on the expense recorded in the financial statements in accordance with FAS 123(R). While stating that "no one approach to disclosure of stock and option awards addresses all the issues regarding disclosure of equity compensation," the SEC, in proposing to revert back to the original reporting method, appears to be acknowledging that the grant date fair value approach provides the most appropriate snapshot for investors to evaluate prior period equity awards and, in turn, total compensation paid to executives in a given fiscal year. The SEC notes in the proposing release that if a company does not believe that the full grant date fair value reflects a named executive officer's compensation, then the company can provide appropriate narrative disclosure in order to address this consideration.

The change to a grant date fair value method would not necessarily do away with some anomalous results in reporting. For instance, the SEC solicits comments on the difficulties presented with reporting performance-based equity awards, which would be required to be disclosed at the full grant date fair value, even though amounts realized under the awards may be significantly different from the value shown in the Summary Compensation Table. Further, the SEC asks about whether the change back to grant date fair value may introduce variability into the named executive officers included in the table, particularly when executives get a single large grant that covers multiple years of service. While these are fair considerations that the SEC should take into account, it seems that the potential detriments are far outweighed by the clarity that could be achieved by switching to the grant date fair value method.

A Troublesome Result—And a Fix

As a result of the change in presentation of the value of stock awards and option awards in the Summary Compensation Table, the SEC proposes to amend Instruction 2 to the salary and bonus column of the Summary Compensation Table to indicate that a company will not have to report amounts of salary or bonus foregone at the election of the executive in the salary and bonus column; rather, the non-cash awards received in lieu of salary or bonus will be reportable in the column that is applicable to the form of award that is elected.

We view this as troublesome in that shareholders looking at the table will not be able to determine actual amounts of salary and bonus that were converted to stock or options. Shareholders are also entitled to see whether companies have implemented a laudable practice of converting bonuses into stock with long-term holding requirements. This is a positive disclosure that companies and shareholders should welcome. A responsible practice would be to provide disclosure of the amounts of salary and bonus that were converted to equity awards, as well as the conversion ratio. Further, disclosure in the CD&A should provide the rationale for permitting/requiring the conversion of salary and bonus into stock or options. The SEC could address these concerns by requiring footnote disclosure of this information.

Dealing with Award Timing Issues. The SEC solicits comment on whether the Summary Compensation Table should report the aggregate grant date fair value of awards received with respect to services in the relevant fiscal year (even if granted after the fiscal year), as opposed to restricting the disclosure to awards granted during the relevant fiscal year as contemplated in the proposed rule. A lingering concern with the approach of restricting disclosure to just those awards actually occurring in the fiscal year is that it does not adequately take into account the extent to which compensation committees may only award the stock or options after the performance could be determined for the completed fiscal year in which services were rendered. This potential mismatch can tend to complicate efforts to explain compensation decisions in the CD&A, and can lead to the continuing need for "alternative" Summary Compensation Tables which seek to reflect more closely the compensation committee's actions for a particular fiscal year.

Considering a Change in Value Approach. The SEC also solicits comment on whether it should alternatively consider adopting rule changes suggested in a May 2009 rulemaking petition submitted by Ira Kay and Steven Seelig of Watson Wyatt, which advocates that instead of requiring the reporting of equity awards on the grant date fair value or the expensed method, the SEC consider requiring disclosure of the annual change in the value of equity awards, which could be positive or negative depending on the direction of the market. We view as more important the need for disclosure in the Outstanding Equity Awards table (or elsewhere) of the accumulated value of all outstanding equity grants.

Transition Issues. The SEC indicates that it is considering requiring "restated" compensation numbers for the prior fiscal years included in the Summary Compensation Table as a means of addressing comparability of the equity award and total compensation amounts. The SEC indicates that it would not require different named executive officers based on the recomputed total compensation numbers for the prior periods. The SEC solicits comments on this proposed transition approach.

Compensation Consultant Disclosure: An Interim Step?

In our March-April 2009 Special Supplement (at pg 7), we suggested that, among other things, the SEC require disclosure of fees received by a consultant when the consultant performs services for management and the compensation committee. Many concerns have been raised (including by the Obama Administration) about the role of compensation consultants in the compensation-setting process. Under the SEC's new proposals, companies would be required to include additional disclosures regarding compensation consultants hired by the company or its compensation committee.

More Fulsome Disclosure, Including Fees. The proposed rules would require that if a compensation consultant or its affiliates plays a role in determining the amount or form of compensation for the company's executives or directors, and also provides other services to the company, then the company must disclose:

- the nature and extent of the other services;
- the aggregate fees received by the consultant and its affiliates for determining or recommending the amount or form of executive and director compensation, and the aggregate fees for the other services;
- whether the decision to engage the compensation consultant for any other services was recommended or made by management, and
- whether the compensation committee or board approved the other services.

These proposed rule changes are reminiscent of disclosures required for auditors when the independence of auditors was being questioned in the late 1990s. Much like the auditor disclosure requirements, the SEC's proposals may not go far enough (at least in the eyes of some in the Administration, Congress and among investors) in addressing potential conflicts of interest arising from the use of compensation consultants.

Legislative Developments for Compensation Consultants. As part of the package of legislative proposals initially advanced by the Obama Administration and now part of a bill passed by the House entitled the "Corporate and Financial Institution Compensation Fairness Act of 2009," the SEC's proposed disclosure changes could be the tip of the iceberg for compensation committees and their relationship with compensation consultants.

The Corporate and Financial Institution Compensation Fairness Act would take a page out of the Sarbanes-Oxley Act's way of dealing with auditor independence, by directing the SEC to mandate new listing standards of the national securities exchanges. These listing standards would require that compensation committees have the authority and funding to hire independent compensation consultants, outside counsel, and other advisors. Under these standards, compensation committees would be directly responsible for the appointment, compensation, retention, and oversight of the work of any compensation consultants that they retain, and that the compensation consultants would report directly to the compensation committee. In addition, the bill would require that disclosure of whether the compensation committee had retained a compensation consultant satisfying required standards of independence established by the SEC. The SEC would also be tasked with conducting a study of the use of compensation consultants meeting required independence standards and the effects of the use of such independent consultants.

Other Important Areas Where Comment is Solicited—And Our Comments

One of the striking things about the SEC's proposals is how little the agency is proposing to change in the face of such unprecedented public (and policy-maker) anger over executive compensation. We noted in our March-April 2009 *Special Supplement* (at pg 7) that now is an ideal time to implement fixes to address weaknesses in the current disclosure rules (and non-compliance), given the significant momentum toward executive compensation reform. Investors, Congress and others are focused on the need for clear and complete disclosure.

In the proposing release, the SEC does solicit comment (at pages 63-65 of the release, or pages 35092-3 of the Federal Register version), without proposing any specific changes to the rule language, on other potential changes to the executive compensation disclosure requirements, such as expanding the coverage of the rules to all executive officers (not just named executive officers), eliminating or revising the exclusion for the disclosure of performance targets measures, combining the CD&A with the Compensation Committee Report, requiring more disclosure concerning clawbacks, hold-until-retirement policies, gross-ups, compensation plans and internal pay equity, and disclosure about the expertise of compensation committee members.

We are attaching as a Special Supplement to this issue our comment letter highlighting what we view as the most important changes the SEC should adopt now.

Expanding the Scope of Item 402. As noted above, the SEC's proposed rule changes would only expand the CD&A to cover non-named executive officers in the context of how overall compensation policies and practices relate to risk management practices and/or risk-taking incentives, when material. In the proposing release, the SEC asks whether it should require disclosure of the compensation paid to each of the executive officers, not just the named executive officers as determined under Item 402. This approach may very well go too far, in that it may unduly complicate the executive compensation disclosure without providing much in the way of incremental disclosure relevant to how the company and the compensation committee approach compensation decisions and policies. Already, complaints abound about the length and complexity of the tables and the CD&A, and adding to that length may not be justified when sufficient information is already provided by looking strictly at the named executive officers.

Revisiting the Approach on Performance Targets. In our March-April 2009 Special Supplement (at pg 2), we suggested that the SEC adopt an express requirement in the CD&A (and for the narrative disclosure accompanying the Summary Compensation Table under Item 402(e)) which mandates disclosure of performance target levels for completed periods, as well as a requirement to discuss current period or future period target levels, but only if material to an understanding of the discussion and analysis about the company's compensation policies and decisions for the last completed fiscal year. We suggested that this approach could be paired with retaining the competitive harm exclusion, provided that the exclusion would be adequately enforced and fully disclosed when used, coupled with disclosure in all circumstances about how difficult it will be for the executive or how likely it will be for the company to achieve the target levels. The SEC's proposing release opens the door to some further consideration of this topic, soliciting comment on "after the fact" performance target disclosure or, alternatively, elimination of the confidentiality exclusion entirely. We think that the compromise that we previously suggested might be a workable solution here, and provide a means for the SEC to address one of the most significant lingering concerns regarding the effectiveness of the CD&A in adequately explaining a company's "pay for performance" philosophy.

Retooling the Compensation Committee Report—And Director Accountability. The proposing release suggests several alternatives for retooling the Compensation Committee Report, which now serves only as a "furnished" short form report of the compensation committee confirming its involvement in and recommendation for disclosure of the CD&A. The SEC asks whether the "furnished" versus "filed" status should be revisited, or whether a combination with the CD&A is warranted.

One major reason for the lack of meaningful analysis in the CD&A is the absence of greater director accountability for the CD&A. The compromise position adopted in 2006 has not produced the analysis that was hailed to be "the cornerstone" of the 2006 amendments. This can be fixed by returning ownership—and accountability—of the CD&A to the compensation committee. We support making the CD&A and the compensation committee report one filed document.

Clawbacks and Hold-to-Retirement. The SEC notes in the proposing release that "some investors want more information regarding whether compensation arrangements are reasonably designed to create incentives among executives to increase long-term enterprise value." In furtherance of this goal, the SEC asks whether tabular or narrative disclosure should be enhanced to require disclosure about whether a company has "hold to retirement" and/or clawback provisions, and if not, why not.

We think that these types of policies should already be discussed under the principles-based requirements of CD&A—and already are discussed by a growing number of companies. The SEC needs to make this disclosure—and analysis—obligation clear. Discussion of these policies is integral to any discussion of how the company manages risks arising from incentive and equity compensation programs. (See the Summer 2009 issue of *Compensation Standards* at pgs 4-5).

It should not be overlooked that if the SEC takes steps to improve the analysis in the CD&A by requiring a captioned analysis section—and requiring that the compensation committee address in the CD&A the necessary analytic tools utilized and corrective actions taken (as we discussed in the March-April 2009 *Special Supplement* at pg 2)—the goal of getting more discussion of critical considerations such as hold-through-retirement or clawbacks can be realized.

Internal Pay Equity. In the proposing release, the SEC asks: "Are investors interested in disclosure of whether the amounts of executive compensation reflect any considerations of internal pay equity?" Potential considerations in this regard might include, in the SEC's view, disclosures regarding internal pay equity ratios of a company. Again, as we noted in the March-April 2009 *Special Supplement* (at pg 2), the focus should be on revising the CD&A requirement to focus on the identification of the range of potential analytic tools, including specific references to whether the company has utilized tally sheets, a walkaway wealth accumulation analysis and/or an internal pay equity analysis, including how and why the particular analysis was used, the findings from the analysis and then what decisions were made and what compensation changes were considered/implemented and why.

Mandating the disclosure of internal pay equity ratios is an important start that we strongly support, but the ratios must be accompanied with *analysis* (comparing the current ratios with the company's historic ratios)—and an explanation of resultant decisions made by the compensation committee and actions taken. (See the discussion in our Comment Letter, attached as a Special Supplement to this issue.)

Internal pay equity alone, however, will not be enough to provide investors with a complete picture of the company's compensation policies and decisions. In order to make an informed voting decision on say-on-pay and voting for directors, shareholders are entitled to see whether directors on the compensation committee are utilizing the necessary analytic tools and providing in the CD&A the findings and the resultant decisions made and actions taken.

Addressing Complexity. The SEC asks whether disclosure of the number of compensation plans and the number of variables in compensation plans would get at the issue of the complexity and significance of all of the company's plans. Unfortunately, numbers alone do not begin to tell the whole story, and the SEC should consider requiring complete disclosure—in the context of an expanded CD&A requirement addressing risk—of all of the company's compensation plans, so that compensation policies and decisions applicable to the entire organization can be adequately explained.

Gross-Ups—and Section 162(m). The SEC asks in the proposing release whether more disclosure is necessary regarding gross-ups, including a requirement to disclose and quantify the savings to each executive. Given the attention that gross-ups have garnered in recent years, it is unclear why the SEC would not have just proposed this additional disclosure, rather than merely soliciting comment. In our view, principles-based disclosure currently requires such a discussion—as well as inclusion of the amounts that named executive officers receive in excess of the Section 162(m) limits on deductibility of compensation.

The Commission should make these important disclosure obligations clearer to address the oft repeated response: "where does it say in the rule that we have to provide that disclosure?"

Walk-Away Disclosure and Analysis—A Heads Up

Although not mentioned in the proposing release, companies should not lose focus on the need to provide—and analyze—full walk-away numbers for the named executive officers and for the CEO in particular. As part of his June 10, 2009 statement on compensation principles, Treasury Secretary Geithner specifically singled out that "disclosures typically failed to make clear in a single place the total amount of 'walk-away' pay due a top executive, including severance, pensions, and deferred compensation." As we addressed in our March-April 2009 *Special Supplement* and in the latest issue of *Compensation Standards* (at pg 6), principles-based disclosure should drive disclosure of true "walk-away" numbers in the post-employment compensation disclosure required by Item 402(j).

The true walk-away numbers should include not only unvested equity grants, but also previously exercised grants and projected future grants based on the assumption that they will be made on the same basis as the most recent award, as well as projections as to pension benefits (including benefits from supplemental plans). The SEC and institutional investors will undoubtedly be looking closely for such disclosure—and, more importantly, analysis and explanation in the CD&A of the "need" for safety net provisions that balloon such numbers and cushion bad decisions or performance.

Companies and compensation committees may well want to get ahead and start now revisiting plans in light of a walk-away analysis (particularly in light of Treasury's announced concern about walk-away numbers and the need to revisit severance and other safety net provisions). Knowing that the CD&A walk-away analysis will be expected, compensation committees may wish to consider correcting severance and post-retirement provisions that are no longer defensible.

<u>A Model CD&A Walk-Away Paragraph.</u> Because so many companies will be grappling with the CD&A full walk-away discussion and analysis, we will be providing in the upcoming issue of *Proxy Disclosure Updates* a model CD&A disclosure that David Lynn, former SEC Chief Counsel, is drafting now, which will be posted on CompensationDisclosure.com. To access this important issue, those that may not yet be subscribers are encouraged to take advantage of the enclosed no-risk trial or go to CompensationDisclosure.com.

Next Steps—Comments Due Soon!

The SEC has requested comments on the proposals by September 15, 2009. Given the timing of the comment deadline and the relatively limited nature of the proposed changes, it appears that the SEC could adopt these proposals (along with the related corporate governance proposals) in time for the 2010 proxy season. Companies and their compensation committees need to begin thinking now about the above disclosures and how they will be addressed. Given the potential for a new rule in place and the need for companies to address their CD&A analysis shortcomings, this is a topic that can no longer be ignored.

Are You Recognizing Too Much Expense for Your ESPP?

While we firmly believe that employee stock purchase plans are a great program in down markets (see our November-December 1998 issue at pg 1), one unfortunate side effect of declining stock prices is that the statutory limit on the number of shares employees can purchase, *i.e.,* the $25,000 limitation under IRC Section 423(b)(8), and other limitations embedded in the plan can become a problem. A lower stock price means a lower purchase price, which in turn results in employees being able to purchase more shares, ultimately resulting in more employees being subject to these limitations.

For example, let's say that an offering with a six-month lookback and a 15% discount begins when the FMV is $25 per share. If the stock price increases during the offering, the purchase price will be $17 per share and the maximum number of shares employees can purchase under the $25,000 limitation is 1,000 ($25,000 divided by the $25 FMV at the start of the offering). If the plan limits contributions to 10% of salary, a fairly typical provision, only employees earning in excess of $340,000 per year would be in danger of exceeding the $25,000 limitation, and only if they contributed the maximum that the plan allows. (The aggregate purchase price of 1,000 shares would be $17,000. For employees to be able to contribute enough funds to purchase this many shares, they would need to earn $170,000 over the six-month offering period). There probably aren't that many employees earning this level of compensation—and those that do earn this are most likely executives, which we recommend that companies exclude from the ESPP anyway.

On the other hand, if the stock price declines during the purchase, say to $12 per share on the purchase date, any employees earning more than $200,000 per year could find that their purchases are subject to the $25,000 limitation. The purchase price would be $10.20 per share, resulting in an aggregate price of $10,200 for 1,000 shares. (Despite the decline in price, the shares are still valued at the $25 FMV from the beginning of the offering for purposes of the $25,000 limitation and employees are still limited to purchasing no more than 1,000 shares). At this price, employees contributing 10% of their compensation only need to earn $102,000 over the six-month offering period to purchase the maximum allowed under the statutory limit.

You might scoff that this steep a decline isn't likely over a six-month period, but we suspect that there are a number of companies that would beg to differ. And despite the dire predictions about the impact of FAS 123(R), there are companies that still provide for longer offering periods, *e.g.,* 12 or 24 months, where a decline of this magnitude wouldn't be that steep.

Limits Reduce Employee Returns

We have previously touted the virtually "guaranteed" 17.65% return that ESPPs offer to employees (see our November-December 1998 issue at pg 1), but this is a situation where employees won't realize that return. Let's revisit our example above in which the FMV declines to $12 on the purchase date and assume that an employee contributed $11,000 to the offering. The employee will be subject to the $25,000 limitation and, thus, purchases only 1,000 shares, receiving a refund of $800 with no interest. The employee contributed $11,000 and received stock worth $12,000, a return of only 9%.

If the employee had realized that the purchase would be limited, the smart thing to do would have been to not contribute any funds in excess of $10,200. This would have enabled the employee to allocate the $800 that otherwise would not earn any return to another investment. This is a good argument for allowing employees to reduce their contributions to $0 without withdrawing from the plan (see our January-February 2009 issue at pg 3).

This is also a good reason for the plan to prohibit contributions in excess of $21,250 (85% of $25,000), since that is the maximum purchase price permitted under the $25,000 limitation. Ideally this limitation should be applied on an annual basis, although enforcement may be complicated for a plan with six-month offerings. One workaround would be to limit contributions to each six-month offering to $10,625 ($21,250 divided by two), but, in a rising market, this works to employees' disadvantage. Let's say that a six-month offering (with a lookback and 15% discount) begins on January 1 when the FMV is $25 per share (resulting in a purchase price of $21.25 if the FMV increases by the purchase date). At the start of the subsequent offering, the FMV has appreciated to $30 per share, resulting in a purchase price of $25.50. In this scenario, employees are better off purchasing as much stock as possible in the first offering; limiting contributions to $10,625 per offering forces employees to divide their purchases between the two offerings, ultimately paying more for the stock they purchase over the one-year period.

Warning Employees About Limits. A best practice here would be for companies to monitor employees' progress towards the $25,000 limitation or any plan limits and warn employees when it appears that they will be subject to these limitations. To our knowledge, there's no easy way to do this. Since the number of shares employees will purchase is dependent on an unknown—where the purchase price ends up—the only way to do this is to estimate how many shares employees will purchase based on their forecasted contributions at their current rate and the current stock price. This is obviously an estimate and should be communicated as such. If it should turn out that the stock price recovers before the end of the offering, then fewer employees will be subject to the limitations. But, at least with this notification, employees can make an informed choice about their contribution level and there should be fewer unpleasant surprises on the purchase date.

Accounting Considerations

We had assumed that the refunds resulting from employees being subject to these limitations would be treated as forfeitures and the company would go back and adjust the amount of expense recorded for the fewer number of shares that employees purchased. But, it turns out, this isn't the case. Instead, the possibility of employees being subject to a statutory or plan limitation should be taken into account when estimating the initial fair value of the plan.

Where an ESPP includes a lookback and a discount, and doesn't limit the number of shares employees can purchase based on the price at the beginning of the offering (this type of limit prevents employees from purchasing additional shares when the price declines and guarantees that employees won't realize a 17.65% return in a down market), the ESPP fair value includes three components: (i) the discount as of the offering beginning, (ii) a proportionate amount of an at-the-money call option granted on the offering beginning date, and (iii) a proportionate amount of an at-the-money put option granted on the offering beginning date (see our May-June 2005 issue at pg 2).

In an ideal world, where there are no plan limits, ESPPs with a lookback and a discount guarantee a minimum return. A put option, which gives the holder the right to sell stock (as opposed to a call option, which gives the holder the right to buy stock), does the same thing; where an investor already owns the stock underlying a call option, a guaranteed sale price guarantees a minimum return. This is the reason for the put option component of the ESPP fair value; the return guaranteed by the ESPP is the economic equivalent of the return guaranteed by a put option.

In the real world, as we have demonstrated, the $25,000 limitation and other plan limits can prevent employees from realizing the promised return. Employees don't have the true economic equivalent of a put option; this should be reflected in the value computed for the put component of the ESPP fair value. Essentially, when valuing the put, the option pricing model needs to take into account the likelihood that employees will be subject to one of these limits and, thereby realize a lower return, reducing the value of the put.

Introducing the Monte Carlo Simulation. To do this, the put option needs to be valued using a Monte Carlo simulation. A Monte Carlo simulation involves the same financial mathematics as the Black-Scholes model, but rather than just running the math once based on a fixed price path, the model simulates many different (about 100,000) random price paths to produce a "normal" distribution of stock price returns. The results of all these different simulations are then averaged into a single fair value. For an ESPP, the model would consider whether or not employees would be subject to a purchase limitation for each random price path and would reduce the fair value accordingly.

Because the likelihood that employees will be subject to a purchase limitation depends on how much they are contributing to the ESPP, employees have to be segregated into groups based on their contribution level (technically, a separate valuation should be performed for each contribution level, but we understand that, from a practical standpoint, five to ten groups are usually sufficient). Once the valuations for each individual group have been computed, the resulting values can be averaged into a single composite fair value for the ESPP.

The Monte Carlo simulation is only necessary to value the put component of the ESPP fair value; the call option component could still be valued using Black-Scholes. But once a company has gone through the effort of implementing a Monte Carlo simulation, it's a simple tweak to have the simulation output a value for both the call and put components. Since the call option component isn't impacted by the purchase limitations and since the simulation involves the same math as the Black-Scholes model, the fair value of the call component will be the same whether the Monte Carlo simulation or Black-Scholes is utilized for the valuation. Thus, it's probably easier to use the Monte Carlo simulation to compute the call option value than it is to rerun the math using Black-Scholes.

Worth the Trouble? For many companies, the ultimate reduction in fair value may not be worth the trouble. The put component of an ESPP is a relatively small portion of the overall fair value. Where an ESPP with a lookback offers a 15% discount, the fair value is comprised of (i) the 15% discount, (ii) 85% of a call option, and (iii) only 15% of a put option (since it is only that 15% discount that is guaranteed). In our original example of a six-month offering beginning when the FMV is $20 per share, if we assume 50% expected volatility, a 1.5% risk-free interest rate, and no dividend yield, the put component is less than 7% of the overall fair value. The participation in an ESPP is going to have to be fairly high, and a lot of employees are going to have to be subject to the various limitations we've talked about, before reducing the value of the put component is going to materially reduce plan expense.

Thanks to Terry Adamson and Liz Stoudt of Radford for bringing this issue to our attention and for their assistance with this piece.

Treasury's Mark Iwry to Speak at 6th Annual Executive Compensation Conference

We're very excited to announce our speakers for the "6th Annual Executive Compensation Conference" that will be held at the San Francisco Hilton and via Live Nationwide Video Webcast on November 10th.

The All-Star cast includes:

- Treasury's Mark Iwry, Senior Advisor to Secretary Geithner
- RiskMetrics' Pat McGurn and Martha Carter
- NY Times' columnist Joe Nocera
- Noted counsel John Olson and Marc Trevino
- Renowned consultants Fred Cook, Ira Kay, Mike Kesner, Doug Friske, James Kim and Don Delves
- Panel of respected Directors
- Investor advocates Ed Durkin, Meredith Miller and Paul Hodgson

Now that Congress is moving on say-on-pay (and other compensation-changing initiatives), you need to register now to attend our critical conferences and get prepared for a wild proxy season. Remember that the "6th Annual Executive Compensation Conference" is paired with the "4th Annual Proxy Disclosure Conference" (held on November 9th)—so you automatically get to attend both Conferences for the price of one. See the enclosed or visit TheCorporateCounsel.net to view the agenda for both Conferences.

A Heads Up. We are experiencing a rush of sign ups for the Live Nationwide Video Webcast. No doubt due to the recognition that the SEC's new proxy disclosure rules (and say-on-pay) will be impacting several different people and departments, more companies and law firms have been taking advantage of the special firmwide rates like never before. We mention this now as a heads up to make sure that your company, your firm (and your client companies) are signed up. Please use the enclosed form that has the special Live Nationwide Video Webcast rates.

Proxy Disclosure Updates—Full Walkaway Model CD&A

As mentioned at pg 9 within, David Lynn, former SEC Chief Counsel, is right now putting the final touches on a key, new model CD&A disclosure which will need to be addressed in this year's proxy statements. The upcoming special issue of *Proxy Disclosure Updates,* David Lynn's and Mark Borges's electronic newsletter, that is part of Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" will focus on this important new full walkaway disclosure, providing not only their new model disclosure, but also invaluable guidance on what to cover and why and how.

To access this critical model disclosure and guidance, any readers who may not yet be subscribers to Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" are encouraged to take advantage of the no-risk trial, which entitles you to the rest of this year free. To take advantage of this special offer—and to gain immediate access to the upcoming issue of *Proxy Disclosure Updates*—we encourage you to return the enclosed form, or go to CompensationDisclosure.com and gain immediate access. [Note that all subscriptions to the Annual Service are on a September year, so current members will need to make sure your renewals are in to ensure that you will have immediate access to the upcoming special issue.]

The New 2010 Edition of Lynn, Borges & Romanek's "Executive Compensation Disclosure Treatise & Reporting Guide"

Mark Borges and David Lynn are right now completing the 2010 version of "The Executive Compensation Disclosure Treatise & Reporting Guide," addressing everything you will need to comply with the SEC's new executive compensation rules—including the impact (and ramifications) of the newest rule changes on all upcoming proxy statements. This comprehensive, practical body of work—over 1,000 pages—is chock full of explanations, annotated sample disclosures, analysis of situations that you may find yourself in, and more.

The Treatise, together with the invaluable *Proxy Disclosure Updates* newsletter, is part of Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" on CompensationDisclosure.com. By purchasing one, you get both. The 2010 Treatise will be posted online as soon the final edits are made and mailed as soon as it is printed in early October—so you will have it in hand as a critical guide to refer to during this upcoming, challenging proxy season. [Note again, that because all subscriptions to the Treatise and Annual Service expire in September, it is time to renew your subscription to Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" now to ensure that you receive the Treatise and gain immediate access to the online version on CompensationDisclosure.com—as well as the upcoming special issue of the *Proxy Disclosure Updates* newsletter.]

We encourage all our readers who have not yet discovered the Treatise and Annual Service to try a no-risk trial—now. Please use the enclosed form to receive a $100 or more discount.

Romeo & Dye's Forms and Filing Handbook

We are pleased to announce that Peter Romeo and Alan Dye's fully revised "Section 16 Forms and Filings Handbook" has now been published and mailed. It includes a number of new—and critical—model forms. To receive this "must have" resource, try a no-risk trial to "Romeo & Dye's Section 16 Annual Service" by going to the upper right corner of the Section16.net home page, or call (925) 685-5111.

The Year for *The Corporate Executive*

With the year ahead shaping up to be the most eventful and challenging in decades, *The Corporate Executive,* with David Lynn's critical insights and guidance, will be more invaluable than ever. We are truly grateful for the kind words we have been receiving these days not only from long-time subscribers, but also from many new subscribers. It appears that we have struck a chord with many more departments within corporations (from legal, to HR, to Investor Relations), and many more lawyers within law firms.

In recognition of the need we are serving this year, in particular (and in view of the tight economic times), we are extending a special offer for new subscribers which will enable anyone to receive *The Corporate Executive* at no risk. We encourage you, our loyal readers, to bring *The Corporate Executive* to the attention of friends and colleagues who might benefit from the newsletter in the challenging days ahead. In these challenging times, this is the one newsletter you cannot afford to be without.

Renewal Time

Renewal time is upon us. Please return the enclosed renewal form to ensure that your subscription does not lapse.

—JMB/DL/BB

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Attachment C

Summer 2009 issue of *Proxy Disclosure Updates*

Borges & Lynn's Summer 2009

Proxy Disclosure *Updates* on CompensationDisclosure.com

Practical guidance for those drafting and reviewing compensation disclosures

Our Analysis of the Executive Compensation Disclosures

Before we turn our full attention to the SEC's proposed revisions to its executive compensation disclosure rules, we wanted to spend a few minutes reviewing (or is it reminiscing about?) the 2009 proxy season. We believe it's fair to say that, last July, we anticipated that the third year under the (now not-so-new) disclosure requirements would be a staid affair, and that we would be preoccupied with refining the disclosure of incentive compensation programs (and their attendant performance metrics and target levels) and applying the SEC's "plain English" principles to the increasingly complex Compensation Discussion and Analysis. As we now know, things certainly didn't turn out this way.

Neither of us foresaw the extent of the global economic meltdown triggered by the subprime mortgage mess that overwhelmed the business world just two short months later; nor the overwhelming legislative and regulatory responses to that meltdown that are still unfolding. Both of these historic developments figured prominently in the executive compensation disclosures of numerous companies during the 2009 proxy season—and are likely to influence disclosure considerations for the foreseeable future.

As a result of the precipitous decline in the stock markets, as well as the problems in the overall economy, many compensation committees were faced—some for the first time—with annual bonus plans that would pay out significantly below expected levels, if at all. Others found that the target payouts under their outstanding multi-year cash plans (some of which had been launched earlier in the year) no longer were achievable, thereby gutting their long-term incentive compensation programs. And most saw the value of their executives' outstanding equity awards take significant hits, creating motivation and retention concerns requiring an immediate response.

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Moreover, these challenges were not limited to the just-completed fiscal year. The weakening economy made it difficult for most companies, and their boards of directors, to calibrate their incentive compensation programs going forward; forcing them to reconsider and, at times, restructure their short-term and long-term plans. At the same time, Washington began to mobilize, issuing a steady stream of laws and regulations that imposed a series of new—and often substantive—standards on the executive compensation practices of companies receiving federal assistance. As companies began to prepare their proxy statements in this environment, several decided to "get ahead of the curve" and incorporate into their disclosures aspects of these standards that had broader application and were likely to be of interest to investors outside the financial sector.

The Real Value of the '09 Disclosures

We feel safe in saying that next year's executive compensation disclosures will look significantly different from what we've seen up to this point. At a minimum, the SEC's own changes to its executive compensation disclosure rules will see to that. In addition, it's still unclear whether the Obama Administration and Congress will enact specific corporate governance and executive compensation reforms before year-end. Further, several of the most influential institutional investors are in the midst of updating their executive compensation policies in response to the ongoing economic turmoil, which, along with the annual policy updates from the major proxy advisory firms, could have a profound effect on both compensation and disclosure practices. Finally, the looming inevitability of "Say on Pay" will, at a minimum, force companies to reevaluate, if not redraft, their executive compensation disclosures.

While we will have to wait a little longer to learn the precise regulatory and disclosure framework that's going to apply during the 2010 proxy season, we would like to highlight several disclosures we came across this spring that touched upon a number of the subjects that we expect companies may have to confront in their next proxy statement.

A note of caution, however: while some of these examples do a good job addressing the issue at hand, most were drafted "in the dark;" that is, without the benefit of formal regulatory guidance, the opportunity to see how other companies handled similar issues, feedback from the investor community, and, often, a full understanding of the precise scope of the issue being addressed. As such, they should be treated as "first drafts" of disclosures that, inevitably, will be refined and expanded over time.

The Impact of the Global Economic Crisis

The far-reaching impact of the global economic crisis affected the executive compensation practices and decisions of many companies, and put the SEC's overarching goal of "principles-based" disclosure to the test as never before. Generally, we found CD&As, the centerpiece of every companies' executive compensation disclosure, to be longer during the 2009 proxy season, a trend which started last year. However, unlike 2008, when the longer discussions were largely a reaction to the extensive comments from the SEC Staff the year before, the 2009 changes appear to have been driven by the impact of the economic downturn on executive compensation programs. Here's how Quanex Building Products Corporation began its 2009 CD&A:

> The recent economic volatility has influenced our executive compensation programs due to its effect on the market. In this environment our fiscal 2008 Annual Incentive Award (AIA) incentive plan paid out below target levels. We also reviewed the continued appropriateness of the performance measures in our incentive plans and adopted performance measures that reflect the Company's focus on profitability and cash flow for fiscal year 2009. We also decided to defer any salary increases for executives. While our normal schedule would have called for merit increases and

salary adjustments during the December Compensation and Management Development Committee meeting, we decided to defer those decisions until more is known about the direction of the market. We also considered the changes in stock price and its effect on the Company's long-term incentive grants. The impact of a lower share price generally results in more options and restricted shares being granted to plan participants. We reviewed the resulting number of shares required to meet our long-term incentive target values and determined that number was within a reasonable range and therefore made no changes to our target award values.

In some instances, companies were required to disclose how their compensation committee addressed the shortfall in annual compensation, including whether their response was to waive performance conditions or approve discretionary bonuses. Prospectively, companies had to confront the current economic uncertainty and the challenges in setting future performance objectives. As a result, many found themselves devoting significant attention to how their executive compensation programs would be revised for 2009 and the foreseeable future; disclosure that they had not previously been required to make.

Figuring Out How to Look Back

With the turmoil in the financial markets, in addition to describing their overall executive compensation philosophy and program framework, many companies found themselves with annual bonus plans that didn't pay out or long-term incentive compensation plans with performance objectives that were no longer viable.

As a result, these companies found it necessary to explain how their compensation committee determined the payouts under their annual bonus plan (specifically where performance results fell short or were non-existent) and any interim compensation decisions that accompanied that action (such as discretionary bonuses or plan adjustments). While, in numerous instances, there were shorter discussions of the formal annual bonus plan (and little need to discuss performance target levels because there was no payouts), this was frequently offset by the additional discussion necessary to explain and justify these interim compensation arrangements.

Cabot Corporation provided disclosure of just this situation:

> Following its determination that no bonuses could be paid to the named executive officers under the STI Plan, the Compensation Committee evaluated their performance during the year and nonetheless awarded each a discretionary cash bonus to recognize his significant and numerous contributions to the Company and strong leadership during the 2008 fiscal year. In particular, the Committee considered each officer's significant contributions to achieving the following: (i) a smooth CEO leadership transition; (ii) the development and implementation of a new corporate vision, strategy and organizational structure; (iii) our overall financial performance in light of the steep and continual increase in raw material costs; (iv) a strong safety, health and environmental record, measured by our low total recordable safety incident rate, the severity of those incidents and a low number of environmental nonconformances; and (v) marked improvement in our new business development activities demonstrated by the license agreement for the commercialization of Cabot Elastomer Composites, successful expansion of the use of our cesium formate drilling fluids in operations outside of the North Sea, and increased revenue in our Aerogel business. The Committee also considered issues of internal equity that would arise from the payment of a bonus to others in the Company.
>
> The amount of each award was based primarily on the executive officer's performance, the level of his responsibilities, and internal equity considerations. The Committee also

> considered the bonus amounts paid to each executive officer for fiscal 2006 and 2007, and competitive market data from the Industry Comparison Group and compensation surveys. In assessing each officer's performance and determining award amounts, the Committee acknowledged the following achievements:
>
> – In determining the amount of Mr. Prevost's award, the Committee recognized Mr. Prevost's swift transition into the CEO position and his leadership in developing a new corporate vision, strategy and organizational structure. Mr. Prevost also managed to mitigate some of the effects of the negative economic environment by focusing the management team on product margins, cash management and optimizing the resources of the new business areas.
>
> – Mr. Brady's award recognized his leadership in the Rubber Blacks business, which achieved strong financial performance despite the unprecedented increase in raw material costs during the fiscal year. The award also recognized Mr. Brady's leadership of the newly created Americas region.
>
> – Mr. Mason's award recognized his strong leadership of the finance, IT and purchasing functions. In particular, Mr. Mason managed a critical cash management phase linked to the exceptional raw material price increases.
>
> – Mr. Berube's award recognized his strong leadership on corporate governance matters and effective management of legal matters and corporate risk. Mr. Berube also provided critical advice to the Board of Directors during the CEO transition.
>
> – Mr. Cordeiro's award recognized his leadership and management of the Supermetals business during difficult market conditions as well as his role in the development of the new corporate strategy.

Figuring Out How to Look Ahead

Companies also paid greater attention to their current year's compensation policies and practices than in prior years. While the executive compensation disclosure rules only require a company to address actions that were taken after the end of its fiscal year to the extent that such information could affect a fair understanding of its senior executives' compensation for the last fiscal year, because many companies took steps to modify their pay programs and policies in light of the uncertain economy, there was significant additional discussion of these modifications (and the reasons therefore) in most CD&As. These "enhanced" disclosures ranged from a brief sentence at the end of the discussion of each impacted individual compensation element to entire sections devoted to explaining how the company's compensation program had been reevaluated and changed for the current year.

Sonic Foundry provided a typical disclosure:

> In response to increased losses Sonic initiated cost reduction efforts in January 2008, including voluntary reductions in base compensation of certain executives. Mr. Buinevicius reduced his base compensation from $331,000 to $231,000 while Mr. Schmidt reduced his base compensation from $258,000 to $183,000 and Mr. Minor from $232,000 to $162,000. Following improved results in our second and third fiscal quarters, the base compensation was restored to previous levels in July 2008. On November 3, 2008, the Committee approved base salary increases of approximately 4% effective immediately for Mr. Buinevicius from $331,000 to $344,000 and for Mr. Schmidt from $258,000 to $268,000. On November 10, 2008 the Committee similarly approved a 4% increase for Mr. Minor from $232,000 to $241,000. After its review of all sources of market data as described above, the Committee believes that the adjusted base salaries and the bonuses described below are within its targeted range for total cash compensation.

And KeyCorp offered a brief description of the changes that its compensation committee made to its annual incentive plan:

> In light of the difficulty in predicting the economy the Compensation Committee has decided to take a different approach in setting performance goals for the CEO and his direct reports as well as for the 2009 Incentive Plan. The Compensation Committee set minimum goals regarding KeyCorp's capital position for any incentive pool to fund for the named executive officers. Additionally, financial goals with broad ranges of performance measuring operating income, credit quality, earnings per share and improvement in economic profit added were established. When evaluating the performance of the CEO and his direct reports or determining any incentive pool funding for 2009 under the Incentive Plan, the Compensation Committee will assess performance against these goals as well as improvement in liquidity, return on risk weighted assets, proactive leadership and results relative to peers. Regarding those peers, the Compensation Committee determined that Wells Fargo, given its new size, should no longer be a member of the peer group for 2009. The Compensation Committee will make any additional changes that may be required by ARRA.
>
> The economic uncertainty discussed above will also be problematic for the Compensation Committee in establishing long-term goals. Therefore the Compensation Committee set cumulative goals using the same metrics as the 2009 Incentive Plan for the 2009-2010 long-term incentive cycle for a two-year performance cycle (rather than a new three-year cycle).

While the need for such disclosure in the future will depend upon the specific facts and circumstances facing each company, it is clear that companies understand their obligation to explain significant changes to their executive compensation program on a prospective basis if such information is material to an investor's understanding of the program.

The Impact of the Reporting Requirements for Equity Awards

The one technical requirement that continued to present challenges for companies during the 2009 proxy season was the reporting of equity award values (including stock options) in the Summary Compensation Table and, to a lesser extent, in the related Grants of Plan-Based Awards Table. The required disclosure of this information based on the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with SFAS 123(R) led to a resurgence in the use of "alternative" summary compensation tables to restate equity award values and, correspondingly, total compensation using the full grant date fair value of awards made during the last completed fiscal year.

General Electric offered one of the better examples of an alternative SCT, with its associated disclaimer that this information was not a substitute for the amounts reported in the required SCT:

> The following table reflects the MDCC's view of 2008 compensation actions for Mr. Immelt and includes the actions described above. The MDCC considered salary, bonus, the potential value of performance share units (PSUs) granted in 2008 and the 2006 through 2008 long-term performance award.

	Year	Salary	Bonus	Equity awards[1]	Long-term performance awards	Total
Jeffrey R. Immelt, Chairman of the Board and CEO	2008	$3,300,000	$ 0	$2,044,650	$ 0	$ 5,344,650
	2007	3,300,000	5,800,000	4,713,000	0	13,813,000

[1] Represents the full grant date fair value, in accordance with SFAS 123R, of PSUs awarded that can only be earned if certain performance goals are met for the five-year performance period.

> *The above table is presented to show how the MDCC viewed 2008 compensation actions for Mr. Immelt, but it differs substantially from the 2008 Summary Compensation Table required by the SEC and is not a substitute for that table*. A major difference between the 2008 Summary Compensation Table and the above table is that the stock and option awards columns in the 2008 Summary Compensation Table represent the expense recognized for financial statement reporting purposes with respect to equity awards granted in the years shown and prior years. The equity awards column in the above table represents the full grant date fair value, in accordance with SFAS 123R, of equity awards granted in the years shown only. In addition, the 2008 Summary Compensation Table includes compensation amounts based on the change in pension value and nonqualified deferred compensation earnings. The above table excludes these amounts because the MDCC considers these programs in the context of its assessment of the overall benefit design and not as an element of its annual compensation decisions. Likewise, the MDCC does not consider in its annual compensation decisions the items included as All Other Compensation in the 2008 Summary Compensation Table on page 23, and these items are therefore excluded from the above table.

Other companies, such as Devon Energy Corporation, used one or more supplemental tables to explain the intricacies of the often arcane expense recognition requirements of SFAS 123(R) and how they produced the amounts being reported in the SCT. This challenge was particularly exacerbated in 2009 by the effects of compensation reversals (resulting from forfeited awards or changes in the probable outcome of performance-based vesting conditions) that led to negative numbers in the Stock Awards and Option Awards columns. As a result, the integrity of the total compensation figure presented in the SCT, which had come under fire previously because of the complexities of SFAS 123(R), took another (and, as noted below, perhaps fatal) hit.

Contrasting Reported Values with Economic Values

Companies that experienced a significant drop in the market price of their common stock during 2008 faced a new, and potentially disturbing, problem with their 2009 disclosure, as the year-end market values of the outstanding equity awards held by their named executive officers differed dramatically from the SFAS 123(R) accounting values that were required to be disclosed. Consequently, several companies, in an effort to highlight this disparity (which often was a contributing factor to a compensation committee's decision to grant a special retention award or accelerate the grant date of an annual award) chose to offer a comparison between the amounts required to be reported and the "true" value of those awards in the hands of their NEOs.

Mueller Water Products addressed this issue by providing two supplemental tables (one for stock awards and the other for options) comparing the awards' compensation expense as reported in the SCT with their actual fiscal year-end market values. SunTrust Banks took a slightly different approach: adding columns to its Grants of Plan-Based Awards Table and Outstanding Equity Awards at Fiscal Year-End Table. The additional GPBAT column (which was placed next to the required Grant Date Fair Value column) reported the current market value of the stock options and restricted stock awards that were granted during 2008. The additional OEAFYET column reported the aggregate market value of all outstanding stock awards. (There really wasn't any need to address the outstanding stock options since they are all deeply "underwater," although where that isn't the case, presumably, the unrealized appreciation of each outstanding stock option would also be reported.)

This approach was used by several companies during 2009 (see, for example, the Viacom proxy statement), with the principal reporting distinction being whether the market value figure was based on the year-end value of the company's common stock or its value at the time that the proxy statement was filed. While it's likely that the SEC's proposed change to the SCT reporting requirements for equity awards will eliminate the justification of most "alternative" SCTs, if the stock market remains volatile through the end of the year, these "accounting value vs. market value" disclosures may proliferate. It's also an effective way to demonstrate the alignment of executive and shareholder interests that is an underlying rationale for most equity awards.

The Impact of EESA and ARRA

With the imposition of substantive compensation standards on financial institutions and other companies receiving governmental assistance under the Emergency Economic Stabilization Act of 2008 ("EESA") and the American Recovery and Reinvestment Act of 2009 ("ARRA"), as well as the growing call for executive compensation reform, many companies attempted to stay ahead of the curve by addressing some of the topics covered by the new standards in their disclosure, as well as highlighting the provisions of their existing compensation program that already addressed some of these areas.

Risk Assessments

Several companies, drawing from the requirement in EESA, as amended by ARRA, that financial institutions conduct "risk analyses" of their executive compensation programs to identify any unnecessary or excessive risks that could threaten the viability of the institution, included risk assessment disclosure in their CD&As. An example of a non-financial sector company that included such disclosure in its CD&A was United Technologies:

> UTC's compensation strategy is intended to mitigate risk by emphasizing long-term compensation and financial performance metrics correlated with shareowner value. While annual cash incentives play an appropriate role in UTC's executive compensation program, overweighting this form of compensation can encourage strategies and risk that may not correlate with the long-term best interests of the Corporation. As described under "Pay Mix," only about 10% of total compensation is fixed for the CEO and other NEOs, while approximately 90% is tied to performance. Long-term incentives comprise over 85% of this performance-based compensation, appropriately so in view of the long life cycles of UTC's products and services. The long-term

> program's specific focus on three-year earnings per share (EPS) and total shareowner return (TSR) targets aims to reward significant and sustainable performance over the longer term. Comparably, the focus on share-based compensation, in combination with executive share ownership guidelines set independently by the Committee, reflects the program's goals of risk assumption and sharing between executives and shareowners.

The content of these disclosures varied widely; in large part a reflection of the absence of any specific guidance on how to analyze compensation-related risk. Even though the specific risk assessment varied from company to company, many of these discussions, as illustrated by Becton Dickinson's disclosure, tended to enumerate the features of the compensation program—such as bonus caps, stock ownership guidelines, and compensation recovery policies—that are intended to mitigate risk:

> The Compensation Committee believes that this combination of cash and equity-based compensation supports the objectives of our executive compensation program described above. First, these vehicles allow BD to provide a competitive compensation package based on prevailing market practices. At the same time, a significant portion of target compensation is variable "at-risk" pay tied to both short-term performance (PIP awards) and long-term performance (Performance Units and SARs). The Compensation Committee believes these awards support our pay-for-performance philosophy by linking pay amounts to our level of performance and the achievement of our strategic goals. Finally, the ownership stake in BD provided by equity-based compensation, the extended vesting of these awards and our share ownership guidelines (discussed on page 31) align the interests of the named executive officers with our shareholders and promote executive retention. At the same time, the Committee believes, with the concurrence of its independent consultant, that, as a result of our balance of long- and short-term incentives, our use of different types of equity compensation awards that provide a balance of incentives, and our share ownership guidelines, BD's executive compensation program does not encourage our management to take unreasonable risks relating to BD's business.

Unless the SEC provides specific requirements in connection with the adoption of its disclosure enhancements, companies will probably have to turn to the financial sector for guidance on how to conduct a risk assessment. While most financial institutions that were required to conduct a review over the last nine months disclosed that fact in their proxy statements, only a few offered any type of look into the process itself. One such institution was TCF Financial Corporation:

> Under the provisions of the CPP, the Company must comply with certain requirements regarding executive compensation throughout the time the Treasury Department holds on interest in Company shares.
>
> One such requirement is that the Committee must review senior executive officer incentive compensation with the Company's senior risk officer to ensure that those arrangements do not encourage "unnecessary or excessive risks" that threaten the value of the Company. This must be done no later than 90 days after the Treasury Department's purchase of Company shares. Thereafter, the Committee must meet at least annually with the senior risk officer to discuss and review the relationship between the Company's risk management policy and practices and the senior executive officer incentive compensation arrangements. The term "senior executive officer" is defined as the Chief Executive Officer, Chief Financial Officer, and the three most highly compensated employees other than the Chief Executive Officer and Chief Financial Officer.

The Committee met with the Company's senior risk officer in January 2009 and has concluded that:

– The risks to which TCF is subject can be categorized as credit risk, interest rate risk, price risk, liquidity risk, foreign currency translation risk, transaction risk, compliance risk, strategic risk and reputation risk, with the most significant risks identified as credit quality risk and interest rate risk.

– Base salaries are a sufficient percentage of total compensation (about 50%) to discourage unnecessary or excessive risk taking by senior executive officers.

– The annual cash incentive program for senior executive officers does not encourage unnecessary or excessive risk, as the incentive can be reduced or withheld if the Committee determines an executive has caused the Company to incur such risk.

– Restricted stock and stock options awarded by the Company do not encourage unnecessary or excessive risk because they are vested over a period of time that focuses the executive on the Company's long-term interests.

– Anticipated holdings by TCF executives of significant amounts of Company stock through their employment, and historically well into retirement, provide considerable incentive for them to consider the Company's long-term interests while still employed.

In making the foregoing determinations, the firm of Towers Perrin was engaged to provide advice on the Committee's process for determining whether executive incentive compensation encourages unnecessary or excessive risk.

The Committee has concluded that the overall compensation structure for senior executive officers does not encourage unnecessary or excessive risk taking by the executives. While the variable elements of compensation are, on the one hand, a sufficient percentage of overall compensation to motivate executives to produce superior results, the fixed element on the other hand, at about 50% of total compensation, is also a sufficiently high percentage of overall compensation that the Committee does not feel that unnecessary or excessive risk taking is encouraged by the variable elements.

The Committee has also concluded that the short-term component of TCF's executive incentive compensation plan (annual cash incentive) does not encourage unnecessary or excessive risks to the Company. The Chief Executive Officer will subjectively determine the incentive based on his evaluation of the executive's performance, subject to final approval by the Committee. The Chief Executive Officer and Committee have sole discretion in making their determinations, and in reducing or withholding the bonus to any executive if either determines that the executive caused the Company to incur unnecessary or excessive risk. For these reasons, the Committee does not believe the short-term component of executive compensation encourages unnecessary or excessive risk. Mr. Cooper is not eligible for a cash incentive in 2009.

The Committee also notes that a short-term component similar to the current one (but tied in its entirety to a corporate financial goal) has been in place for many years, and there is no evidence it has encouraged unnecessary or excessive risk taking. For example, TCF's bonus plans have not encouraged executives to assume excessive or unnecessary credit risk, such as by entering the sub-prime lending business, syndications, or derivative transactions, and they declined to do so despite the temptation of higher short-term profits that might have resulted from such business activities. Additionally, while there is a short-term component to the incentive compensation plans for other senior executive officers, there is none for the Chief Executive Officer. His incentive compensation is entirely long-term in nature, and the Committee does not believe strategies that benefit the Company in the short-term will be encouraged or tolerated if they would be to the Company's long-term detriment.

The Committee has also concluded that the long-term component of TCF's executive incentive compensation plan consisting of restricted stock and stock option awards does not encourage unnecessary or excessive risks to the Company. In the Committee's view, an unearned and unvested stock or stock option award should be outstanding for each executive at all times to serve as an incentive to remain with the Company and to focus the executive on all elements of Company performance that influence long-term share price appreciation, including losses attributable to the most significant risks facing the Company. Vesting requirements over a three-year or four-year period for the restricted stock and stock option awards encourage executives to avoid short-term actions that are to the Company's long-term detriment. The Committee's elimination of the corporate financial goal as a vesting requirement further assures that the long-term incentive does not encourage unnecessary or excessive risk.

The Committee considered several other factors that will tend to discourage unnecessary or excessive risk taking by senior executive officers. Historically, TCF executives have continued to hold a significant amount of Company stock well past retirement, and the Committee anticipates this will continue for current executives who are approaching retirement age. These substantial holdings by Company executives of TCF Stock, both before and after they retire, subject them to the possibility of significant market penalties in the event they make decisions that benefit the Company in the short-term but ultimately prove detrimental to the Company's long-term interests. The Committee does not believe it is necessary to impose a minimum stock ownership or holding period requirement due to these significant holdings by Company executives.

Pursuant to Treasury Department regulations, both the short-term and long-term components of TCF's executive incentive compensation plans are subject to new claw-back and golden parachute restrictions. As a condition to TCF's participation in the CPP, all bonuses and other incentive compensation arrangements with the senior executive officers have been amended to provide that during the time the Treasury Department holds an equity position in the Company, the Company may recover (or "claw-back") any payments that were based on materially inaccurate financial statements or any other materially inaccurate performance metrics used to award bonuses or incentive compensation. The claw-back requirement should act as a disincentive to any executive from manipulating financial statements or performance metrics in a way that would assure payment of a bonus award, increase a bonus, assure vesting of a restricted stock award, or increase the value of a restricted stock or stock option award. All employment-related agreements with the senior executive officers have also been amended to prohibit golden parachute payments during the period the Treasury Department holds an equity position in the Company. For these purposes, a "golden parachute payment" is defined as any compensation payments to a senior executive officer due to: (1) involuntary termination of employment, including termination by the Company with or without cause and voluntary termination by the executive for good reason, or (2) in connection with any bankruptcy filing, insolvency, or receivership of the Company. Limits on golden parachute payments in the event of involuntary termination of employment likewise deter any behavior not in the Company's best interests.

> The Compensation Committee certifies that it has reviewed with the senior risk officer the senior executive officer ("SEO") incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage the SEO to take unnecessary and excessive risks that threaten the value of the financial institution. The Compensation Committee also certifies that it has met to discuss and review the relationship between TCF Financial's risk management policies and practices and SEO incentive compensation arrangements.

Compensation Recovery Policies

One area that drew significant attention during 2009 as a result of EESA and ARRA was whether companies had a compensation recovery ("clawback") policy. While the number of such policies has grown significantly following the enactment of Section 304 of the Sarbanes-Oxley Act in 2002, there was a pronounced increase in the disclosure of these policies during 2009 or, where such a policy did not exist, an explanation of why such a policy was unnecessary.

While most existing policies are somewhat narrower than what is required by EESA, as amended by ARRA (that is, they are triggered only upon a material restatement of a company's financial statements rather than on any material inaccuracy affecting a company's statements of earnings, revenues, gains, or other criteria), we expect that, in future disclosures, companies will be expected to justify the scope and operation of their specific policies.

Here's United Technologies' "clawback" disclosure, which indicates that the company revised and updated its policy in 2008:

> In 2008, the Committee expanded the Corporation's policy on recoupment ("clawback") of executive compensation. In the event of a financial restatement or recalculation of a financial metric applicable to an award, annual bonus payments paid in connection with the year in question, as well as gains realized from vested LTIP awards, are now subject to recoupment with respect to any executive involved in the restatement. In addition, the Committee may require recoupment of awards from other executives based on its review of the facts and circumstances.
>
> The newly-adopted recoupment policy supplements existing protections integrated into UTC's executive compensation program, including:
>
> - Post-employment covenants: These discourage ELG participants from engaging in activities that are detrimental to UTC by restricting the disclosure of proprietary information, the solicitation of UTC employees, and engaging in competitive activities.
> - LTIP clawback provisions: In addition to a clawback triggered by a financial restatement, long-term incentive awards are subject to clawback rules for termination for cause and certain other conduct injurious to the Corporation.
> - Share ownership guidelines: The Committee believes senior executives should have a significant equity position in the Company. Stock ownership guidelines are in place to align the interests of executive officers and other senior leaders with those of shareowners and to encourage a long-term focus in managing the Company. The CEO requirement is five times base salary and the requirement for the rest of the ELG is three times base salary.

Another interesting "clawback" disclosure was provided by McCormick & Co.:

> McCormick's 2007 Omnibus Incentive Plan (the "Plan"), which was approved by stockholders at the April 2, 2008 Annual Meeting, outlines circumstances under which

> share-based and cash-based awards made under that Plan may be forfeited, annulled, and/or reimbursed to McCormick. Such circumstances include: a forfeiture of the gain realized by a participating employee on account of actions taken by the employee in violation of the award agreements issued under the Plan, and/or a finding by the Compensation Committee that a participating employee has been terminated for cause ("cause" means, as determined by the Compensation Committee, (i) gross negligence or willful misconduct in connection with the performance of duties; (ii) conviction of a criminal offense (other than minor traffic offenses); or (iii) material breach of any term of those agreements between the participant and McCormick or an affiliate, as specified in the Plan).
>
> Furthermore, if McCormick is required to prepare an accounting restatement due to the material noncompliance of McCormick, as a result of misconduct, with any financial reporting requirement under the securities laws, then (i) the individuals subject to automatic forfeiture under Section 304 of the Sarbanes-Oxley Act of 2002, and (ii) any participant who (a) knowingly engaged in the misconduct, (b) was grossly negligent in engaging in the misconduct, (c) knowingly failed to prevent the misconduct, or (d) was grossly negligent in failing to prevent the misconduct, is required to reimburse McCormick the amount of any payment in settlement of an award earned or accrued under the Plan during the twelve (12) month period following the public issuance or Exchange Act filing (whichever first occurred) of the financial document that contained such material noncompliance.

While the former provision is technically a "clawback" provision, it's not really the type of provision that investors envision when that term is used today. In the public's mind, a "clawback" provision is a Section 304-type provision, where compensation is disgorged because of financial irregularities. While McCormick's provision doesn't go as far as what is contemplated by EESA and ARRA, its delineation of the categories of individuals subject to disgorgement: the CEO and CFO (the Section 304-covered executives), anyone who knowingly or was grossly negligent in engaging in the covered misconduct, and anyone who knowingly or was grossly negligent in preventing the misconduct, goes farther than most current policies. It will be interesting to see whether compensation reforms or "best practices" compel companies to expand their policies to encompass these broader groups.

Tax Implications

As under the former executive compensation disclosure rules, companies include some discussion in their CD&A about the impact of tax considerations on their executive compensation programs, giving particular attention to the implications of Section 162(m) of the Internal Revenue Code. With EESA's reduction of the $1 million deduction for senior executive remuneration to $500,000 (which was left undisturbed by ARRA), there has been renewed interest in the whether a company's executive compensation is fully deductible.

Unfortunately, only a few companies addressed this matter clearly during 2009. Even fewer disclosed the amount of non-deductible compensation paid to their senior executives and the resulting forgone tax deduction. Notable examples included Eastman Chemical and Abercrombie & Fitch. We believe that this will be an area of focus for many institutional investors in 2010 and expect to see more companies disclose their actual compliance with Section 162(m) and, where not in compliance, the amount of any forgone tax deduction.

Role of Third Parties

Following SEC Staff comments in 2008 regarding enhanced disclosure concerning the role of executive officers and third-party advisors in the compensation setting process, most companies took steps to expand their discussions of this subject in 2009. In particular, many companies provided a more detailed description of how their chief executive officer and other executives are involved in making executive pay recommendations and, in some cases, decisions.

In the case of executive compensation consultants and outside attorneys, many disclosures went beyond the technical requirements of the rules to also address the advisor's "independence;" specifically, whether the advisor has any other business relationship with the company. The disclosure of The Walt Disney Company is illustrative of this trend:

> In October 2008, the Compensation Committee adopted a policy requiring its consultant to be independent of Company management. The policy provides that a consultant will be considered independent if: the firm does not receive from the Company fees for services or products provided to the Company in any fiscal year that exceed 1% of the firm's annual gross revenues; the individual that advises the Committee does not participate directly or by collaboration with others in the firm in the provision of any services or products to the Company without the approval of the chair of the Compensation Committee unless the related fees are, in the aggregate, less than $100,000; the consultant does not provide any products or services to any executive officer of the Company; and the Committee pre-approves any specific engagement of the firm if the estimated cost of the engagement exceeds $500,000. The Committee performs an annual assessment of the consultant's independence to determine whether the consultant is independent. The Committee completed this assessment in December 2008 and confirmed that its consultant is independent under the policy.

Other companies have implemented a flat prohibition on the compensation consultant or other advisors to the board compensation committee performing any work outside of the committee engagement.

The Bottom Line

Undoubtedly, most companies found the 2009 proxy season to be their most challenging under the SEC's new executive compensation disclosure rules, as its "principles-based" disclosure system was put to the test. And, given the anticipated legislative and regulatory response to the ongoing economic crisis, further challenges lie ahead.

While much of the spotlight is likely to be focused on the proposed disclosure concerning the relationship of a company's overall compensation policies to risk and the advisory vote on executive compensation (assuming that authorizing legislation is enacted later this year), the executive compensation standards of EESA and ARRA will also influence the substance of many disclosures. Consequently, it's going to take (at least) one more proxy season before we'll have a clear sense of what a "typical" executive compensation disclosure is going to look like going forward.

What We Did Not See

Unfortunately, many disclosures did not contain the critical analysis that the SEC has made clear should be provided in the CD&A. Too often, an explanation of "to be competitive" took the place of real analysis. When use of tally sheets and wealth accumulation and internal pay equity analyses were mentioned, generally there was little or no accompanying discussion of how they were used, the findings or any resultant actions. Also, it is troublesome that many companies still are not providing the actual amounts paid to the CEO and other NEOs in excess of the Section 162(m) deduction limit.

Further, companies seem to be ignoring (or intentionally avoiding) the need to provide full "walk-away" numbers upon a termination of employment, making the retirement and severance estimates provided in disclosures incomplete and misleading. When shareholders (and compensation committees) do not receive the full walk-away amounts (including accumulated unrealized equity gains and accelerated vesting, etc.), public trust is eroded and "principles-based" disclosure is undermined. (For more on these important fixes, see the March-April 2009 Special Supplement of *The Corporate Executive*.)

Each of us involved in the process—from those advising boards of directors to those who draft and review the disclosures, to institutional shareholders and regulators—must do our part to address these shortcomings and help restore trust and integrity to the system.

Don't Miss the Upcoming Fall Issue

We will be devoting the upcoming Fall issue of Proxy Disclosure *Updates* to new practical guidance about how to comply with the SEC's proxy disclosure requirements—including the new SEC proposals—and what you need to be doing to get up to speed for next year's proxy disclosures, including how to make them persuasive in a "no broker discretionary vote" world. Remember that you need to renew your subscription to *Lynn, Romanek & Borges'* "Executive Compensation Service" to receive this issue since all subscriptions expire in late September.

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Act now by using this registration form for our popular conferences—"4th Annual Proxy Disclosure Conference" & "6th Annual Executive Compensation Conference"—to be held November 9-10th in San Francisco and via Live Nationwide Video Webcast. Here is the agenda for the Proxy Disclosure Conference (we'll be posting the agenda for the Executive Compensation Conference in the near future).

It's Renewal Time: Subscriptions Expire at End of September

As all subscriptions to *Lynn, Romanek & Borges'* "Executive Compensation Service" end 9/30/09, renew now so that we can send you the New 2010 Treatise—updated for the latest rule changes and scheduled for printing in early October.

—MB, DL

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Attachment D

Summer 2009 issue of *Compensation Standards*

Compensation Standards

Summer 2009

The Executive Compensation Newsletter for Directors and Advisors

Important Reading for CEOs (and Directors) Summer Reading of Lasting Importance

With so much happening right now impacting executive compensation, it is important that we not miss some important big picture reading. The following (most of which are short) are "must reads" for CEOs and directors. [Links are provided in the electronic version of this issue posted on CompensationStandards.com.]

– **Treasury Secretary Tim Geithner's Statement on Executive Compensation**—Our lead piece below is devoted to this important Treasury policy statement—and its ramifications to companies, CEOs and compensation committees.

– **Roger Martin's "Managers Must be Judged on the Real Score," and "Scrap Stock-Based Compensation and Go Back to Principles"**—These two important short pieces on FinancialTimes.com by the Dean of the Rotman School of Management were brought to our attention by Fred Cook.

– **Pepsico CEO Indra Nooyi's "The CEO of the Future"**—This thought-provoking speech to the Economic Club of Washington, by one of the most respected CEOs in the country, was also brought to my attention by Fred Cook. In addition to addressing important qualities that CEOs need going forward (particularly the central skill of adaptability), Nooyi focuses on the concept of "performance with purpose":

> Our basic idea was that a company had to marry its performance with its ethical concerns. Its performance and its purpose are not separate entities, they merge. They feed off each other, they need one another. This is a particularly important idea against the backdrop of economic troubles we are in today.

– **Jamie Dimon's Letter to Shareholders**—This very perceptive analysis of the environment that brought on the problems we are all dealing with today—and fundamental flaws that need to be addressed—demonstrates that with corporate leaders like Jamie

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Dimon and Indra Nooyi and many other thoughtful, principled, nimble CEOs, our free enterprise system is in good hands. It will, however, take the leadership of so many CEOs, directors, and those of us that advise companies and boards to restore trust and integrity to the system.

– Joshua Cooper Ramo's "The Age of the Unthinkable"—We discovered this excellent new book in early May. Apparently, so did Indra Nooyi. In her words, "The book concludes with the same message I'm giving you today: This is the era of the fox. This is an age in which curiosity and resilience matter more than uncertainty. In uncertain environments, it isn't any specific asset, intellectual property or competitive position that matters most. Rather, being adaptable and nimble are the characteristics that will separate the winners from the losers over the long term."

– Peter Singer's "How are We to Live—Ethics in An Age of Self-Interest"—Closing out our list (and picking up on Indra Nooyi's point about marrying performance with ethical concerns), we came across Peter Singer's book this summer on a bookshelf in a vacation house on Santorini. We were impressed with how relevant this fast read, first published in 1993, is to today's corporate, professional and personal ethics. This should be "must" reading for our colleagues and employees, and the next generation of leadership.

—JMB

The Obama Administration's Pay Reforms

As we all know, a significant level of public anger has emerged over compensation. The anger is not limited to recipients of bailout money, but has also extended to all public companies and beyond the executive suite. As a result, compensation practices have become a focus of legislators, regulators, shareholders and the public, with a steady stream of reform proposals being advanced in a variety of forums.

With say-on-pay slated to be in place for this upcoming proxy season, anger over compensation policies and practices cannot be ignored. Immediate action is necessary by boards and compensation committees, who must evaluate their overall compensation policies and practices in light of the rapid development of "best practices" that may very well become legislated requirements, and unprecedented shareholder frustration that will result in an increasing level of activism.

Treasury's June 10 Statement—Don't Underestimate its Importance

The Obama Administration has sought to advance compensation reforms with the Treasury Department's June 10 release of broad-based compensation principles, along with specific legislative proposals that are already included in the legislation making progress in Congress. These principles are not limited in their applicability to bailout recipients or financial institutions, and do not (in some cases) only apply to compensation for executives. With the Administration's broad pay reform principles already taking hold, it is important that directors and CEOs take the time now to become familiar with the four key principles that will be guiding the Administration's actions.

To head off more draconian legislative solutions, careful consideration should be given as to how these principles can be implemented quickly, so that companies and their boards will be seen as responsive to shareholder concerns. The Administration's broad principles address the proper measurement and rewarding of performance, the structuring of compensation to properly relate to the time horizon of risks, the alignment of compensation practices with risk management practices, and the appropriateness of post-employment arrangements for executives in terms of the alignment of these forms of compensation with shareholder interests.

Further, the Administration has proposed targeted legislative initiatives on say-on-pay and compensation committee independence that are quickly gaining momentum in Congress. At the same time, the SEC has now proposed rule changes that would enhance compensation disclosures, particularly with respect to the relationship of compensation to risk and the role of compensation consultants. (All these changes are expected to be in place for this upcoming proxy season.)

Principle #1: Calling for a New "Pay-for-Performance" Paradigm

The June 10, 2009 statement by Treasury Secretary Timothy Geithner specifically identifies executive compensation practices as a factor contributing to the financial crisis. In consultation with SEC Chairman Mary Schapiro, Federal Reserve Governor Daniel Tarullo and a group of experts, the Treasury developed four broad compensation principles that all companies—and in particular financial institutions—must consider. In the Treasury's statement, the first principle states:

> Compensation should be tied to performance in order to link the incentives of executives and other employees with long-term value creation. Incentive-based pay can be undermined by compensation practices that set the performance bar too low, or that rely on benchmarks that trigger bonuses even when a firm's performance is subpar relative to its peers.
>
> To align with long-term value creation, performance based-pay should be conditioned on a wide range of internal and external metrics, not just stock price. Various measurements can be used to distinguish a firm's results relative to its peers, while taking into account the performance of an individual, a particular business unit and the firm at large.

The clear import of the first principle is that, while "pay for performance" is an appropriate cornerstone of compensation policies and practices, it does not go far enough as a governing mantra without a closer examination—and calibration—of pay with long-term value creation objectives. In this regard, the Administration is concerned that performance-based compensation which relies too heavily on short-term metrics, including equity value, may create perverse incentives that emphasize short-term gains over the building of long-term value.

This principle calls for a much more nuanced approach to "pay for performance" that requires looking beyond company-specific performance and traditional financial performance measures, such as earnings per share or stock price. In particular, more emphasis on relative performance to peers is called for, with less emphasis on stock price or individual performance measures which, when considered alone, may not provide the appropriate incentives to minimize risk while building long-term value.

The principle calls for a more "diversified" approach to setting performance targets, utilizing "a wide range of internal and external metrics" which should include measurements that can be used to "distinguish a firm's results relative to its peers." Such measures may also take into account individual performance, or performance of a business unit or the company as whole.

This principle should cause compensation committees to review the breadth and depth of their performance measures used for incentive compensation programs, which all too often rely on only a few measures that are largely internally focused. Revisiting decisions about target measures should be closely integrated with evaluating the company's strategic focus and the relative contribution of individuals, and in so doing the compensation committee should seek to provide appropriate incentives for employees while at the same time not encouraging undue or excessive risk.

An important element of the principle is that it refers to both executives and "other employees." This reference is consistent with a broader concern underlying pay reform efforts since the onset of the financial crisis, which recognizes that compensation policies and practices applicable to everyone within a company can be critical in achieving long-term value while minimizing risk. Implicit in the principle is that different performance measures might be appropriate for different levels of employees within the organization, so that the targets for the CEO could be very different from the targets utilized for employees in the sales force.

The principle specifically identifies a practice that is in particular need of attention—benchmarking. The Administration recognizes that too often, companies are relying on external benchmarks to set compensation without properly taking into account company performance relative to peers or performing an internal pay equity analysis. (For more on why and how to implement an internal pay equity analysis, see our Spring 2007 issue of *Compensation Standards* at pg 2.)

The Administration's identification of benchmarks that cause bonuses to be paid without consideration of subpar company performance relative to peers should cause companies and their compensation committees to revisit their benchmarking practices and broaden their perspective to factor in relative performance targets that are appropriately tailored to creating incentives for employees and executives.

Principle #2: Structuring Compensation to Account for Timing of Risks

The second principle outlined in Secretary Geithner's statement indicates:

Some of the decisions that contributed to this crisis occurred when people were able to earn immediate gains without their compensation reflecting the long-term risks they were taking for their companies and their shareholders. Financial firms, in particular, developed and sold complex financial instruments that yielded large gains in the short-term, but still presented the risk of major losses.

Companies should seek to pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm. Asking executives to hold stock for a longer period of time may be the most effective means of doing this, but directors and experts should have the flexibility to determine how best to align incentives in different settings and industries. Compensation conditioned on longer-term performance will automatically lose value if positive results one year are followed by poor performance in another, obviating the need for explicit clawbacks.

In addition, firms should carefully consider how incentives that match the time horizon of risks can extend beyond top executives to those involved at different levels in designing, selling and packaging both simple and complex financial instruments.

Hold-Through-Retirement Policies

Perhaps one of the most significant compensation concerns to be highlighted by the financial crisis has been the mismatch between the timing of performance-based compensation payments and the realization of risk related to the employee's or executive's activity. In effect, the Administration is expressing a concern that compensation is received for performance before the full effects of that performance have "come home to roost." This inherent mismatch can cause the focus of executives and employees to be oriented toward the short-term when bonuses or other forms of compensation can be maximized, while ignoring the long-term, risk-adjusted returns arising from their efforts.

This principle highlights one of the most simple, yet effective, means for addressing the mismatch—requiring executives to hold their equity awards for a specified period of time. Unfortunately, many policies creating stock ownership requirements do not require holding for a period long enough to adequately address the mismatch and focus executives on long-term value creation. That is why so many mainstream compensation consultants are now recommending that companies consider implementing a "hold-through-retirement" policy for top executives, specifying that those executives retain a significant portion of their equity awards for a period extending at least two years after retirement, so as to ensure that their interests are aligned with those of shareholders—and focused on the long term—throughout their careers. (For more on implementing hold-through-retirement policies, see the excellent piece in the Special Supplement to the January-February 2009 issue of *The Corporate Executive*.)

In that connection, companies that grant restricted stock or restricted stock units should not overlook the importance of a long-term hold. The model that Exxon Mobil has in place is particularly well suited for top level executives at a broad range of companies: Requiring that 50% of the grant be held for the later of 10 years from grant or retirement, thus ensuring a long-term focus. (For more on Exxon Mobil's approach, see the September-October 2008 issue of *The Corporate Executive* at pg 2.)

A further change to compensation programs being advocated now in light of this principle is a shift from annual incentive bonus plans toward more long-term incentive bonus plans (*e.g.,* rather than setting bonuses based on annual results, implementing a three-year or five-year plan that reassesses bonuses on an annual basis based on "stretch" performance measures driven by relative performance—and that "banks" bonuses earned until completion of the performance cycle).

A key to ameliorate the mismatch between pay and the time horizon of risk and to provide more significant incentives for long-term performance is to require that a meaningful portion of bonuses be converted to restricted stock with an Exxon Mobil "later of 10 years from grant or retirement" hold. "All upside with no risk of downside" can no longer be a philosophy behind an incentive compensation plan in light of this principle.

The principle discusses structuring incentive programs to avoid explicit clawbacks (note, for example, how Exxon Mobil holds the 50% portion until the time period is satisfied, thus obviating the need for difficult enforcement or clawback mechanisms). We do not, however, think that the Administration is rejecting the notion of effective clawback policies. Over the last few years, companies have been increasingly adopting clawback provisions, but now is the time for companies to reconsider their existing policies or to adopt new policies that go beyond the old "restatement" limitation.

Prior to the financial crisis, the focus of clawbacks was on recovery of compensation in the event of a restatement and/or financial fraud. In light of issues arising in connection with the financial crisis, the focus has increasingly been on clawbacks (or other mechanisms) that can address the mismatch between short-term performance-based compensation and long-term performance, as well as conduct that may ultimately be seen as detrimental to the company.

In designing effective clawback policies, it is critical to determine who is covered by the policy and the specific triggering events that would require repayment. In terms of who is covered, it is important to establish the extent to which an executive officer's responsibility for the triggering event is to be considered. Enforcement is often a difficult question for clawback policies, so structuring compensation in a way that ultimately avoids having to invoke a clawback, while retaining a clawback as the ultimate tool for recovery, remains the optimal solution.

In the current climate, even those companies that have already adopted clawback policies need to reevaluate those policies. The triggering events may be too narrow and fail to deal with circumstances where it turns out that, after compensation decisions have been made, an executive had engaged in conduct that ultimately causes harm to the company and its shareholders. In this regard, companies should consider whether recovery of any annual or long-term incentive compensation paid to executives (not limited to the amounts where payout or vesting has been deferred) may be necessary in situations where recovery reflects the longer term results of the executive's performance, which may not be fully known or understood immediately following the completion of the performance period.

Further, many companies are considering whether the board or compensation committee should have broad discretion to recover compensation in the event that the executives engage in conduct that is detrimental to the company, with such conduct including, but not limited to, the need for a restatement of results, a significant financial loss, actions, decisions or strategies that were not in the company's long-term best interests, or other reputational harm to the company.

Principle #3: Aligning Compensation Practices with Sound Risk Management

In the third principle, Treasury Secretary Geithner targets the consideration of risk in compensation practices, stating:

> At many firms, compensation design unintentionally encouraged excessive risk-taking, providing incentives that ultimately put the health of the company in danger. Meanwhile, risk managers too often lacked the stature or the authority necessary to impose a check on these activities.
>
> Compensation committees should conduct and publish risk assessments of pay packages to ensure that they do not encourage imprudent risk-taking. At the same time, firms should explore how they can provide risk managers with the appropriate tools and authority to improve their effectiveness at managing the complex relationship between incentives and risk-taking.

As with Principle #2, this principle focuses on the relationship between compensation and risk. Echoing a requirement already applicable to TARP recipients, the Administration calls on compensation committees to factor risk assessments into compensation decisions and provide transparency on the risk elements through disclosure of the results.

The SEC has proposed rules requiring more discussion in the Compensation Discussion & Analysis of the role of risk in compensation decision making, and the relationship of risk to compensation philosophies for the organization as a whole (and not just the CEO, CFO and highest paid executive officers). In fact, the SEC has said in the release proposing these rules that disclosure of the extent to which companies perform such a risk assessment is already required with respect to the executive officers named in the compensation disclosure, under the principles-based standards of the Compensation Discussion & Analysis.

As a result of this principle and the SEC's proposed (and existing) disclosure requirements, boards will need to evaluate their policies regarding risk management, and calibrate the policies as necessary to make sure that they properly relate to compensation decisions and the board structure. This process will typically involve:

- Taking an inventory of risks by consulting with management and other employees of the organization (including a risk officer if the company has one), evaluating pay packages and the circumstances with respect to particular business units, and examining existing policies and procedures relevant to risk;

- Making sure the appropriate persons on the board and within the organization are paying attention to risks and have the authority to address the risks; and
- Documenting policies and decisions in the context of risk so that they can be accurately described in the company's SEC filings—including an analysis of how identified risks have impacted compensation policies and practices.

A Heads Up: In connection with the risk assessment obligation, boards should not overlook the need to examine their CEO's and top level executives' long-term incentive compensation plans—particularly stock options and restricted stock grants—to address the need now for adding 50% hold-through-retirement policies to counter the short-term temptations inherent in most option and restricted stock grants. This should be expressly addressed in the CD&A risk discussion.

Principle #4: Reexamining Post-Employment Compensation and SERPs

The fourth principle of the Treasury statement focuses on the extent to which golden parachutes and supplemental executive retirement packages are properly aligned with shareholder interests, stating:

> Golden parachutes were originally designed to align executives' interests with those of shareholders when a company is the potential target of an acquisition. Often, they have been expanded beyond that purpose to provide severance packages that do not enhance the long-term value of the firm. Likewise, supplemental executive retirement benefits can make it more difficult for shareholders to readily ascertain the full amount of pay due a top executive upon leaving the firm.
>
> We should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholders' interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value.

This principle voices a concern that companies should have already been considering: Are provisions that provide for payments upon the termination or retirement of an executive appropriate and aligned with shareholders' interests? In this regard, termination of employment provisions in employment agreements that provide for "golden parachute" benefits are often entered into as a means of addressing competitive concerns when executive officers are recruited, by providing a level of protection to those individuals in order to address the risks associated with moving to a new position.

All too often, these provisions do not "sunset" when the executive has been with the company for a sufficient amount of time to accumulate wealth under the company's plans that offsets the risk of termination due to a merger or other event. Further, when these provisions are put in place, the compensation committee and the shareholders may not get the full picture of the company's obligations, because neither gets a "walk-away" number aggregating all of the amounts that an executive is entitled to upon the occurrence of specific termination events.

In light of this principle, compensation committees should analyze and reassess all of the termination and change-in-control arrangements, as well as supplemental retirement benefits, to determine whether they are necessary and appropriate under the company's current circumstances and the circumstances of the individual executives.

This type of review should occur at least annually. In the course of conducting this analysis, the committee should review wealth accumulation estimates included in tally sheets, as well as the aggregate value of all compensation that would result in the event of each triggering event under the termination and change-in-control arrangements—in other words the total "walk-away" number under the relevant arrangements.

It is instructive that Treasury Secretary Geithner singled out the importance of providing full walk-away numbers in proxy disclosures: "disclosures typically failed to make clear in a single place the total amount of 'walk-away' pay due a top executive, including severance, pensions, and deferred compensation."

The walk-away numbers analyzed by the compensation committee should be disclosed to shareholders in the proxy statement, and must not be based on a "static" analysis. Rather, the walk-away value should include not only unvested equity grants, but also previously exercised grants and projected future grants based on the assumption that they will be made on the same basis as the most recent award. Pension benefits (including benefits from supplement plans) should also be projected out as well in computing the walk-away numbers.

A Heads Up: It is clear that Treasury, the SEC and institutional shareholders will be looking for clearly set forth full walk-away numbers in this year's proxy statements. And perhaps more importantly, they undoubtedly will be expecting a discussion in the CD&A analyzing whether the payments and amounts "are aligned with shareholders' interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value." [For more on what this analysis should look like, see the "Wealth Accumulation/Full Walk-Away Amounts" chart posted on CompensationStandards.com—and see the model CD&A disclosure that David Lynn, former SEC Chief Counsel, is preparing for the upcoming special issue of *Proxy Disclosure Updates* which will be posted on CompensationDisclosure.com. To access this important issue, those that many not yet be subscribers are encouraged to take advantage of the enclosed no-risk trial or go to CompensationDisclosure.com.]

The Administration's Legislative Proposals

As part of announced compensation principles, the Administration noted areas where it could seek to promote accountability and transparency through legislation targeted at shareholder input into the compensation process and the role of compensation committees and their advisors. In furtherance of these goals, the Administration recently delivered draft legislation to Congress that would require enhanced compensation committee independence for listed public companies, as well as advisory votes on executive compensation. The concepts of this legislation have already been incorporated into a bill entitled H.R. 3269, the "Corporate and Financial Institution Compensation Fairness Act," which was approved in the House on July 31, 2009.

The Administration's proposed legislation would direct the SEC to adopt rules requiring the national securities exchanges to adopt strict listing standards for the independence of compensation committee members that closely track the provisions applicable to audit committee members adopted as part of the Sarbanes-Oxley Act of 2002. In addition to requiring the highest level of independence, the listing standards would need to provide that compensation committees have authority and funding to retain consultants and counsel, and that such consultants and counsel also be independent from management.

The Administration's proposed legislation would also require that all public companies soliciting proxies or consents for an annual meeting provide for a separate advisory shareholder vote on the compensation of executives as disclosed under the proxy rules. An additional non-binding vote would be required for any compensatory arrangements of executive officers relating to mergers, acquisitions and similar extraordinary transactions when proxies or consents are solicited in connection with such a transaction.

Given that these legislative proposals have already cleared the House and appear to be gaining momentum in the Senate, companies and their compensation committees must begin preparing for the prospect of a say-on-pay vote for executive compensation. Now is the time for compensation committees to take the Administration's four principles to heart in upcoming meetings and act to implement the policies outlined above. In addition, compensation committees must consider the issues shareholders will be analyzing when making voting decisions on compensation policies, including:

- the quality of the executive compensation disclosure;
- the link between pay and performance, including whether compensation programs factor in appropriate performance measures and take into account the time horizon of risk;
- the presence of—and justification for—employment agreements, severance and change-in-control provisions, as well as supplemental retirement benefits;
- pay disparities among executives;
- perquisites; and
- the presence of critical compensation policies, such as internal pay equity, meaningful clawbacks and a hold-through-retirement policy.

With action now, compensation committees can avoid the negative consequences of appearing unresponsive in the face of such overwhelming government support of compensation reforms.

Clawbacks: SEC Finally Uses Its Sarbanes-Oxley Authority

In mid-July, the SEC announced an action to clawback bonuses and stock profits from a former CEO under Section 304 of Sarbanes-Oxley. The SEC asked the U.S. District Court of Arizona to order the former CEO of CSK Auto Corporation, Maynard Jenkins, to reimburse the company for more than $4 million that he received in bonuses and stock sale profits while the company was committing accounting fraud. This is the third Enforcement action that the SEC has brought regarding CSK's alleged accounting shenanigans, which resulted in two restatements (one of them charges four of the company's executives with wrongdoing, but not the former CEO).

Although this is not the first Section 304 action from the SEC, it's the first one where the "clawee" isn't alleged to have violated the securities laws. The SEC has brought very few 304 actions since the provision was enacted seven years ago, mainly because of the uncertainty over what constitutes the "misconduct" required by the provision.

There is no requirement in Section 304 that the CEO or the CFO from whom the reimbursement is sought have any involvement in the events that necessitated the restatement. Indeed, the statute doesn't require any showing of wrongdoing or fault at all. And remember there is no private right-of-action under 304—only the SEC can enforce it.

So what type of "misconduct" did the SEC find here? For starters, the SEC's press release refers to the CEO as the "captain of the ship." Did the SEC decide that the captain is responsible for the ship and that alone is enough to find "misconduct?" We don't think so.

Based on a cursory reading of the SEC's complaint, we believe the SEC found that the captain engaged in some "misconduct," but that misconduct didn't amount to a violation of the securities laws. There's not a lot of meat in the SEC's allegations to explain what role the former CEO actually had in the accounting fraud, leaving the SEC open to criticism. But maybe that's the SEC's point—that merely being the captain of the ship while rampant fraud occurs on your watch is "misconduct" enough. We've posted memos analyzing this case in the CompensationStandards.com "Clawback Policies" Practice Area.

At a minimum, the SEC's action seems like a wake-up call to CEOs and CFOs of companies that have had restatements due to some accounting misconduct: you are not safe, the SEC may come after you. And hopefully, this action will spur companies to attempt to enforce their own clawback policies (Equilar reports more than 64% of the Fortune 100 now have them; compared to just 17% in '06). We're not aware of any company that ever has (although it's possible it has happened behind closed doors). We imagine companies sometimes deal with situations where it's not clear if their own clawback policy—or Section 304—applies. Or if it does apply, whether it's prudent to seek recapture from the executive (weighing cost/time of litigation; indemnification issues, etc.).

Rather than decide to just move on and not do anything, it's time to put teeth into those clawbacks as we wrote about in the article from our Winter 2008 issue of *Compensation Standards* entitled "Ten Steps to a Clawback Provision with "Teeth."

Treasury's Mark Iwry and SEC's Deputy Director Shelley Parratt to Speak!

We're very excited to announce that Treasury's Mark Iwry, Senior Advisor to Treasury Secretary Geithner, and the SEC's Deputy Director Shelley Parratt have joined our All-Star cast and will serve as the keynotes for our upcoming pair of Conferences: "6th Annual Executive Compensation Conference" and "4th Annual Proxy Disclosure Conference."

Now that Congress is moving on say-on-pay (and other compensation-changing initiatives), you need to register now to attend these critical conferences and get prepared for a wild proxy season by using the enclosed form or going to CompensationStandards.com. Remember that these Conferences are paired together—so you automatically get to attend both Conferences for the price of one. They will be held November 9-10th in San Francisco and via Live Nationwide Video Webcast. See you there.

—JMB/BR

Compensation Standards is tailored for the busy director, quarterly issues that do not overload directors with useless information—rather, this newsletter provides precisely the type of information that directors desire: practical and right-to-the-point. Plus, each issue includes timely compliance reminders to help directors avoid inadvertent violations (which also help advisors with their compliance tasks).

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