

# Practical Guidance for Drafting Compensation Disclosure Under the New Rules

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## ■ Additional Information

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**Today's discussion is not intended as a technical overview of the new rules, but rather to address their practical application. We are assuming everyone has a basic understanding of these new rules.**

For a comprehensive review and analysis of the SEC's final rules please see: <http://www.pearlmeyer.com/sec>

The material in this presentation *Practical Guidance for Drafting Compensation Disclosure Under the New Rules* is intended to provide information of general interest in a summary manner and should not be construed as individual legal advice. Readers and participants should consult with their lawyer or other professional counsel before acting on the information contained in this presentation.

# ■ Agenda

- **Set the Tone**
- **The Great Performance Target Debate**
- **Whose Report Is It?**
- **Answer “How”**
- **Answer “Why”**
- **Important Questions That May Get Overlooked**
- **Good Versus Bad Disclosure**
- **Unintended Consequences?**
- **Other CD&A Tips and Pitfalls**
- **Everything Accounting**
- **Tables and Narrative**

## ■ Set the Tone – first thing!

### Set the tone up front

- **We're unique and here's how and why**
  - This is an opportunity to tell your story
  - Establish context
- **The story has a beginning, middle and end**
  - ...and sometimes a prequel
  - ...and sometimes a sequel
  - The tables should support your story
  - Link to 10-K, performance discussions, press releases, etc.
    - » What did you already say? 8-K or other previous disclosures
  - Don't just answer questions asked

## The Great Performance Target Debate

- **Do we have to report performance metrics and targets?**
  - Confidentiality vs. Materiality
  - Has guidance been offered?
  - Measure vs. Goals
  - If nothing else, answer the question, “How likely is achievement?”

# ■ Whose Report Is It?

## Whose report is it anyway?

- **Who is the writer?**
  - Management?
  - Counsel – internal or external?
  - Compensation consultant?
- **What voice should it be in?**
  - The Board?
  - Management?
- **Plain English**

### **Be Specific!**

- How the plans work
- How the plans interact
- Allocation/mix between equity and cash
- Allocation/mix between fixed and incentive
- Benchmarking and peer groups

## ■ Answer “Why”

### **Be Specific!**

- Why the company offered a specific program
- Why the company paid that amount (bonus, equity grant etc.)
  - **Performance**
  - **Benchmarking**
  - **Philosophy**
  - **Special situations**

## ■ Important Questions That May Get Overlooked

- **Materiality – is it material? If so, must be discussed**
- **Backdating discussion is not just for options**
  - And it's not just for bad practices either
- **How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation**
- **Impact of accounting and tax treatment**
- **Post-employment payments – how and why**

## ■ Good Versus Bad Disclosure

- **Is there good or bad disclosure?**
  - Is the bonus column bad because it is not formulaic?
  - Is it bad if the plan does not have threshold or maximums?
  - Bad news is not bad disclosure

## ■ Unintended Consequences?

Disclosure requirements may result in plan design changes

### *Drivers*

- **Desire not to disclose targets**
  - Opens a window
- **Inherent favorable disclosure bias to formula-based plans**

### *Potential Results*

- **May drive plan design away from formulas**

### *Intended consequences*

- **Grant methodologies**
- **Perquisites**

- **Report vs. Treatise - Multiple areas of repetition**
  - Board processes (407(e)) vs. the role of executive officers (402(b)(xv))
  - Termination Payments – CD&A discussion of why vs. narrative or tabular discussion of how much and discussion of what’s in the employment agreements
  - Pension and Retirement Payments – why vs. how much
  - Explain in a footnote or refer to the table/CD&A?
- **The old “Attraction, Retention & Motivation” objectives aren’t bad, but need to be tied to specific compensation decisions**
- **Plain English is not that easy**

## Accountants Rule!

- The annual accrual may be higher or lower than the annual grant value in any given year
- Full grant date fair value relocated to new column (I) of the Grants of Plan-Based Awards Table
- If equity award vests upon retirement, and NEO is retirement-eligible, full grant date fair value continues to be reported in the SCT
- Forfeitures are disregarded in SCT (not Grants of Plan-Based Awards Table) at time of grant, but may be considered at time of actual forfeiture
  - » Service condition vs. Market condition

## Impact of reflecting grant values based on accounting:

### Assumptions

New rules - accounting charge

Vesting 3 year Graded

Grant Date	Grant Value	2004	2005	2006	2007	2008
7/1/2004	\$ 100,000	\$ 16,667	\$ 33,333	\$ 33,333	\$ 16,667	
7/1/2005	\$ 500,000		\$ 83,333	\$ 166,667	\$ 166,667	\$ 83,333
7/1/2006	\$ 100,000			\$ 16,667	\$ 33,333	\$ 33,333
Annual Disclosure Value		n/a	n/a	\$ 216,667	\$ 216,667	\$ 116,667

### Assumptions

Original rules - grant date value

Vesting 3 year Graded

Grant Date	Grant Value	2004	2005	2006	2007	2008
7/1/2004	\$ 100,000	\$ 100,000				
7/1/2005	\$ 500,000		\$ 500,000			
7/1/2006	\$ 100,000			\$ 100,000		
Annual Disclosure Value		n/a	n/a	\$ 100,000	\$ -	\$ -

## Summary Compensation Table

- **Who's in and who's out?**
  - Status of “Katie Couric” rule
- **No annualization of incoming/outgoing executives**
- **Bifurcated Bonus Disclosure**
  - *Bonus column* is discretionary or guaranteed, and *Non-Equity Incentive Plan Column* is performance-based
    - » Outcome of performance target substantially uncertain at the time established, plus communicated to executive
    - » Payout in combination of cash and stock
    - » 162(m) plans
    - » Positive discretion goes into Bonus column
    - » Wherever it is, identify it as the company's annual bonus
  - Report in SCT when earned; report “possible” range in Grant Table even if already earned

## ■ Summary Compensation Table (continued)

### ■ Equity Awards

- Footnotes will need to explain assumptions underlying the layers in the SCT
- CD&A and Narrative essential to explaining outcomes
- Timing issues for equity became easier and more complicated at the same time

## Summary Compensation Table - Example

Long-term equity based incentive plan pays out in shares at end of a 1-year performance cycle which began on 1/1/06. Potential awards are denominated in dollars, but payable in restricted stock once the Board reviews performance and approves the grants on March 15, 2007. The threshold, target and maximum amounts under the plan are \$750, \$1,000 and \$1,250. Actual performance results in a \$1,100 award. When the Board approves the award and the grants are made on March 15, 2007, the FMV of the restricted stock is \$10. Assume the grant cliff vests on 12/31/09. How should this grant be reported?

- In the Stock Awards Column of the SCT, report \$275 ( $\$1,100/4$ , the grant value over the three years' of vesting plus the one year of performance)
- In Grants of Plan Based Awards Table:
  - » Column (b) show 1/1/06 as the plan "grant date"
  - » Columns (f), (g) and (h) would show \$750, \$1,000 and \$1,250 as estimated "possible" awards
  - » The actual grant of stock would be reported in 2007. Nothing related to this grant would be reported in column (l) because the grant date is in 2007

## Summary Compensation Table (continued)

- **Grants Table – what if you don't have a threshold and max?**
- **Negative Pension Values and aggregation**
- **Earnings on Non-Qualified Deferred Compensation**
  - Not above-market if invested in same instruments as those provided under tax-qualified plans
- **All Other Compensation**
  - Don't forget termination payments actually paid
    - » When does a payment become "due"?
    - » What about 401(k), deferred compensation payouts upon termination?
  - ESPP discounts
- **Perquisites**
  - No incremental cost
  - Reimbursed Expenses
  - Mixed Use Perquisites
  - Allocations

## ■ Outstanding Equity Awards Table

- **Lengthy Inventory Table**
- **Grant-by-grant reporting of options mandatory**
  - Stock may be aggregated, but some are reporting grant-by-grant as well
- **Awards may roam around the columns for a few years**
  - May require footnote explanation year after year
- **Strangely, no need to report intrinsic values of awards, but some are adding a column**

## Options Exercised and Stock Vested Table

- Typically a shorter table
- Show all stock awards – not just restricted stock
- Report gross (not net) number of stock-settled SARs

## ■ Pension Table

- **Plan-by-Plan Basis**
  - Save discussion for “why” for the CD&A
  
- **Use financial reporting assumptions**
  - Exception for “normal retirement age” or earliest age to receive retirement without penalty
  - No pre-retirement decrements
  
- **Measurement Period**
  - September 30 vs. Year-End
  - Annualization in year of change

## ■ Non-Qualified Deferred Compensation Table

- **Include all increase and decreases from investments**
  - Should be able to match year-to-year changes
- **Don't forget to footnote what you've already disclosed in current SCT**
  - May also go back and track past SCT disclosure, but may add to burden
- **Timing Issues**
  - Annual Incentive Bonus for 2006 is not paid out until February, 2007 and deferred
- **Dividends**

## ■ Termination and Change in Control

- **Tables are not required, but most are choosing to report in tabular format**
- **These tables are lengthy**
- **Reported either by individual, plan or event**
- **By event:**
  - For Cause
  - Voluntary Termination
  - Death
  - Disability
  - Without Cause or with Good Reason Prior to CIC
  - Without Cause or with Good Reason Upon or after CIC
  - Early Retirement
  - Normal Retirement
  - Upon CIC (“single trigger”)
- **Definition of event**

# Termination and Change in Control

- **Valuation Issues**
  - Vested and Unvested Equity
  - 280G
  - Present Value vs. Annuities
- **“Plans and Policies” are broadly defined**
  - Exclude medical, retiree medical, 401(k), etc.
- **Pension and severance payouts reported elsewhere**
- **Narratives, narratives, narratives!**
  - Clearly stated assumptions and explanation of tables critical
  - Ranges and caveats permissible

## ■ Director's Compensation Table

- **Mini-CD&A – tell the story**
- **Disclosure for anyone who served during year, even if no longer there or not standing for re-election**
- **Include consulting fees**
- **Inside Directors who do not receive extra pay for Director service**

## ■ Closing Remarks

- **Even “bad” disclosure is good disclosure**
- **The remedy for confusion and mistakes in reporting in the tables is your opportunity to describe and explain in the CD&A and narratives**
- **Follow rules for CCR disclosure**
  - Don't add without repeating in CD&A
- **For final review, consider having a non-lawyer, non-compensation profession read it and ask them if they get it**

## ■ Our Speakers

- **Mark Rosen**, Managing Director in the Charlotte office of PM&P, has consulted on executive and Board compensation issues for 20 years for a broad range of public companies, as well as tax-exempt organizations and academic institutions. Mr. Rosen has extensive experience with benchmarking, plan design, governance issues, and tax and accounting considerations.

Mr. Rosen holds a B.B.A. and an M.S. in Accounting with a specialty in Taxation from Texas A & M University and is a Certified Public Accountant.

- **Deborah Lifshey**, a Vice President in the New York office of PM&P, specializes in advising clients on compensation matters from a legal perspective, including corporate governance issues, contracts and reasonableness opinion letters. She is a graduate of the Industrial and Labor Relations School at Cornell University and holds a J.D. from the University of Florida College of Law.