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What kind of time pressures do companies face in complying with the SEC's new rules for proxy disclosure?

Things will be toughest for calendar-year companies, which must report under the new rules in their Spring proxies, leaving just a few months to implement major upgrades to internal data collection processes. Non-calendar year organizations generally have a cushion of several additional months to bring their systems into line with the new rules before having to report under the new rules later in 2007. That also gives them the added advantage of learning from the experience of companies making the initial disclosures. Along with examples of the new tabular and narrative disclosures required, the later filers will get a preview of how the SEC, investors and the media react to specific aspects of the expanded reporting – in other words, the proverbial "Holy Cow" disclosures most likely to raise public hackles.

Another big challenge is the fact that disclosure isn't about just numbers anymore. The SEC's new rules include a large qualitative element. At numerous places throughout the compensation disclosure, most notably the central Compensation Disclosure and Analysis (CD&A), companies must provide a narrative explanation for shareholders – without boilerplate and in "plain English" – of the strategy and rationale behind the pay plans in place. Further, the reasons for utilizing one particular element as opposed to another (e.g.,, cash vs. equity) must be outlined. This will be a major challenge at many companies where there has not been a specific pay strategy in the past or where decision-making processes have not been well documented.

How should companies begin tackling expanded disclosure?

By mapping out the big picture – what information is needed, who will be responsible for collecting it and who will be the central keeper of that data.

The first step is identifying the specific additional information needed under more detailed disclosure requirements and who – inside or outside the firm – should be responsible for gathering data on the myriad components of executive pay and benefit programs. Much of this data has either not been reported previously, or reported in a different form.

The new rules will greatly increase the reporting role of actuaries, stock record keepers, attorneys and compensation consultants. Accounting, finance, payroll & human resources departments will also be more actively involved role in preparing the disclosure. Moreover, while historically, those various

parties have worked fairly independently of one another, going forward they will need to work in tandem on many issues. For example, the added reporting on option grants now will state not just the number of shares (generally provided by payroll or human resources), but other information such as the accounting cost of the grant, which will now require the involvement of the accounting and finance departments. Newly required pension reporting requires payout projections and lump sum estimates, which will necessitate the involvement of plan actuaries where there was no participation before. Legal, stock administration, actuarial and HR professionals all will have a hand in the reporting of executive payouts under different post-termination arrangements.

Next, for purposes of producing the disclosure, the company must designate a central repository for all the data that is collected. It is not clear what functional department is best suited to collect the data, but human resources, legal or finance are the best candidates.

Finally, the company and its Compensation Committee must decide who will lead the writing of new disclosure, particularly the new Compensation Disclosure and Analysis. It is likely that the decision will be based on the particular circumstances at a given company. I believe it is unlikely that Compensation Committees will have the resources to assemble the disclosure on its own, so that the bulk of disclosure will be provided by the company for review and discussion by the Committee.

How can companies ensure the process is completed in time for the next proxy season?

By immediately mocking up what the expanded disclosure will look like. It's a great deal of information to assemble and organize in only a few months. The Compensation Committee will need to thoroughly review all the actions taken during the past year, checking whether discussions and votes are fully documented and filling in the blanks to the greatest extent possible.

Mocking up disclosure also serves as a governance check. One of the SEC's central goals in expanding disclosure is to give shareholders the necessary information to evaluate the merits of compensation programs, including the much-touted link between pay and performance. But expanded disclosure will also give Directors and management a much better understanding of the programs in place, including any program shortcomings. Similarly, Directors will get an idea of program optics – how previously unreported details of compensation and benefits look in black and white. Directors then can address problems by instituting the necessary program changes, which can also be reported to shareholders in the same proxy.

What kind of program issues are likely to surface once the proxy is mocked up?

Examples would be overly generous termination arrangements, unexpectedly large accruals of deferred compensation or supplemental retirement plans or costly perquisites. For example, if reported values for executive perquisites are unexpectedly high, the Board can make adjustments to the program prior to the end of the calendar year and disclose the actions taken in the CD&A. In addition, pay for performance misalignment could be unearthed.

What about reporting compensation for additional employees who are not executive officers?

One of the biggest tactical challenges is the last remaining proposal on disclosure that has not been formally adopted by the SEC at this point. It would require disclosure of the compensation of up to three unnamed non-executive officers whose compensation exceeds that of any one of the NEOs. That might include, for example, an ex-founder who is focused on technology development and has not previously been subject to disclosure. The proposal would include only those employees with policy-making roles and specifically exempt employees such as entertainment personalities or professional athletes

This will be a highly sensitive issue for many senior executives, since their identity will be relatively easy to determine from the disclosure on the basis of their job title. Companies should immediately begin determining who might be reportable and tracking their compensation, including one-time payments

such as retention or relocation amounts that could catapult an individual into the discloseable category. We expect that the proposed rule, which is currently subject to a 45-day comment period, will be implemented substantially as proposed.

What is the Compensation Committee's role?

The Compensation Committee is ultimately responsible for executive compensation. Given most Committees' limited resources, they will likely rely on company management to prepare the bulk of the disclosure. However, it will be incumbent on the Directors to review, understand and, where appropriate, edit or add information to the CD&A and other information in the disclosure. Along with evaluating the more extensive information collected and determining that the compensation programs are presented fairly, members will need to establish more rigorous Board processes for reporting the discussions and actions that take place at meetings, as well as establish a schedule of meetings that adequately addresses all aspects of compensation governance.

Unfortunately, until now Committee members at many companies have had little to do with composing the Compensation Committee Report (CCR) or other aspects of compensation disclosures. It is imperative that members be briefed as soon as possible on their new role, particularly their obligations with regard to the new CD&A and revamped CCR. Much like the argument successfully made by Directors in the Disney case, Committee members might not have fully understood all of the programs under their purview. Under the new disclosure regime, however, it is clear that Committee members will have a much harder time arguing they didn't understand the ramifications of pay programs.

To download more information on the new SEC disclosure and other compensation issues, please visit http://www.pearlmeyer.com/.

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