

As We See It

Doing Disclosure Right

When it comes to data analysis, the general rule of thumb is “garbage in, garbage out.” Information must be not only technically correct, but clear, consistent and directly relevant to the question being asked. Otherwise, conclusions based on faulty data are likely to be misleading or incorrect. As regulators seek to improve the ability of shareholders to better understand executive compensation, they must steer clear of some potential disclosure pitfalls.

The SEC is currently assessing the extensive public commentary submitted in response to its proposal to dramatically increase required disclosure of executive and Director compensation starting in 2007. The new rules are intended to provide shareholders with easy proxy statement access to key data that, in many cases, is currently omitted, obscured or scattered in one of countless other corporate filings. Such disclosure is vital to determining whether the level and delivery of executive compensation is appropriate to the marketplace and effectively linked to corporate performance.

As We See It, it is critical that the SEC address the concerns expressed by our Firm, along with hundreds of other individuals and organizations, in response to the agency’s request for commentary. While generally excellent, in certain respects the proposal as currently drafted could muddy the disclosure waters. Rather than accurate and comparable data, presentation of some components of pay under the proposed rules would be too little, too much or too vague.

The general concerns our Firm has conveyed to the SEC can be summarized as follows:

Methodology Shopping

The ultimate value of performance-based pay such as stock options, or of contingent compensation related to change-in-control or retirement, depends on future events, whether stock market performance or life expectancy. If the SEC does not specify the permitted methodologies for making these predictions, companies

will naturally pick assumptions that produce relatively low values. The SEC should address:

- Disclosure of valuation assumptions under FAS123R on a grant-by-grant basis
- Disclosure of assumptions used in determining pension values
- Determination of the date, stock prices and other variables for change-in-control estimates
- Assumptions used for valuation of aircraft perquisites

Too Little Information

Full disclosure entails an in-depth view of provisions and payouts of all components of executive compensation. Among the elements that should be added to any list of new disclosures:

- Potential payouts under annual and long-term performance plans for threshold, target and maximum performance
- A three-year historical comparison of actual performance and payouts for performance-based incentive plans
- Inclusion of all assumptions underlying FAS123R calculations in the proxy, rather than forcing investors to track down information in other public filings
- Additional “matching” disclosure of equity awards to permit tracking of individual awards, including the original grant date, exercise price and FAS123R value; vesting and/or exercise dates; and gains realized
- The value of and rationale for any non-deductible compensation paid to an executive in excess of the

- IRS’s “one million dollar pay cap”
- Details of post-employment payment provisions, such as single or double trigger, vesting requirements, walkaway provisions, etc.
- Details of non-balance sheet investment opportunities provided to executives
- The signature of the Compensation Committee on the CD&A, not just the PEO and PFO, as currently proposed
- Performance Graph – the current proposal suggests eliminating this graph, but we believe this simple requirement provides important information to investors

Too Much Information

Shareholders are entitled to information on compensation and pay policies directly related to corporate performance and governance. Other disclosures may present an unnecessary regulatory burden and pose potential privacy issues for the disclosed employees. Among such troublesome new provisions in the current SEC proposal:

- Inclusion of pay data for up to three non-executives, most likely salespeople, traders, commission-based positions and other highly paid individuals
 - Such employees do not set corporate policy and their compensation is not overseen by the compensation committee
 - Such disclosure, even without individuals’ names, may promote corporate voyeurism without offering much value from an investor’s viewpoint
- Disclosure of returns on deferred compensation earned and deferred by the executive in prior years
 - Transparency should be limited to information about company contributions and executives’ above-market earnings
- Disclosure of compensation consultants’ contacts with executives in the course of carrying out an assignment
 - Such interactions with management are necessary and routine, and requiring specific identification cannot help but imply to shareholders a degree of impropriety

Apples-to-Oranges Comparisons

The SEC omitted some key reporting parameters needed to ensure that reporting of data is standardized across companies, without which shareholders will be hard-pressed to compare programs among companies.

What is needed:

- Definitions of “compensation” with respect to retirement, as well as of assumed “Normal Retirement Age” and “Early Retirement Age”
- Separate reporting of compensation opportunities when awarded and of compensation realized in the year earned (particularly in the case of performance-based awards)

Double Counting

Overstating CEO compensation is as misleading to investors as understating pay levels. As currently described, the Summary Compensation Table would require companies to report some payments more than once. To eliminate redundancy, we suggest:

- Reporting the face value of restricted stock or restricted stock units, but not re-reporting the additional value attributable to dividends, as the face value of such awards has already taken the value of dividends into account
- Reporting increases in the fair value of repriced or modified awards over the fair value attributed to the original awards, but not re-reporting the entire new fair value of the repriced or modified award

More proxy information is not necessarily better. In finalizing the new rules, we trust the SEC will use as its guideline whether the additional compensation disclosure will truly further the ability of investors to judge whether companies are delivering on their pay for performance promise.