SEC FINAL PROXY DISCLOSURE RULES: WHAT YOU NEED TO DO NOW

The SEC's new proxy disclosure rules for 2007 will require a major overhaul of existing practices in the months ahead. Among the key challenges for companies and their Compensation Committees is developing new internal systems to identify, collect and maintain far more detailed data regarding compensation programs for Directors and highly paid employees.

The rules also will recast governance roles at many companies by significantly increasing the involvement of the Compensation Committee in the disclosure process and making disclosures subject to CEO and CFO certification under Sarbanes-Oxley. Boards must put in place processes for conceptualizing and writing newly required proxy narratives intended to describe the rationales behind the programs disclosed.

This update reviews some of the immediate steps needed to help ensure full compliance with the new rules in time for the upcoming proxy season. It should be read in conjunction with our Client Alert: SEC Issues Final Rules on Executive and Director Compensation Disclosure, a more detailed presentation of the new requirements that is available on the Pearl Meyer & Partners website at www.pearlmeyer.com.

Get Your Board Involved

Provide Needed Education and Guidance

It is essential to ensure from the start that Board members and top executives realize their heightened responsibilities for disclosure and the potential for increased liability.

Immediate Steps:

- Verify that the CEO, CFO and full Board understand that the Compensation Discussion and Analysis (CD&A) will be covered under Sarbanes-Oxley certification requirements as a filed document.
- Make sure the CEO and CFO are aware that they will now be required to certify the disclosure, and make sure they are comfortable with the manner in which the numbers are calculated well in advance of the proxy filing date. Start now to assemble this data – certifying officers do not like surprises.
- Revise the Compensation Committee's charter as needed to reflect updated processes and procedures that are needed to produce the CD&A, Compensation Committee Report (CCR) and other new items of disclosure.

Strengthen Governance Processes

Historically, many corporate Boards have had relatively informal processes for providing oversight of compensation programs. The new rules, as well as the heightened probability of shareholder litigation in the current environment, require that Boards introduce standardized and well-documented policies for deliberating, implementing and recording the details of compensation decisions and programs.

Immediate Steps:

- Codify written compliance guidelines that formalize new processes and procedures used in data collection and decision-making.
- Use accepted Board "best practices" to help preserve Directors' business judgment protection.
- Schedule additional Compensation Committee meetings now, and consider forming a special Disclosure Committee. The Committee needs to be prepared to devote the time needed to review and refine new disclosures, particularly in the first year of implementation.

Collect the Data

Assign Data Collection Responsibilities

There is a relatively narrow window in which to design and put in place new processes to capture the expanded breadth and depth of compensation data that companies must now report to shareholders.

Immediate steps:

- Identify the provider of data for each element of compensation, whether external (i.e., actuarial firms, stock plan administrators and compensation consultants) or internal (i.e., accounting, payroll and human resources functions). Complex requirements, such as reporting payouts under various post-termination arrangements, will require that some data providers work together for the first time.
- Appoint a "Keeper of the Data" to serve as the central repository for all the disclosure data collected – most likely one or more individuals from the Human Resources, Legal and/or Finance Departments.
- Identify newly required data that may not be currently collected, such as individual and company contributions to deferred compensation programs.

Track executive officers who will now be disclosed, and beware of potential optics issues for these individuals

Immediate steps:

- Identify potential non-specified NEOs and start tracking their total compensation on an ongoing basis.
  - Don't forget the "sleepers." Track amounts earned but not paid under non-equity incentive plans, tax gross-ups, amounts paid or accrued in connection with termination of employment, matching contributions, one-time payments related to retention, relocation or special bonuses, and any changes made to the terms of SERPs or deferred compensation programs.
  - Consider revising the D&O questionnaire to elicit additional information.

- Determine the non-specified NEOs with reference to the new elements of compensation that must be considered above and beyond base salary and annual bonus.
- Assess whether the annual bonus paid to each NEO will now fall in the Bonus column (which is more likely to be negatively perceived as a purely discretionary bonus) or the Non-Equity Incentive Plan Compensation column (which may be more positively viewed as performance-based).
- Examine deferred compensation investments for features that might produce reportable compensation to NEOs in the Summary Compensation Table, such as above-market interest.
- Evaluate SERP/defined benefit plan features, focusing on high leverage features such as extra years of service, the definition of compensation and averaging formulas.
- Notify NEOs of "pledged share" disclosure and consider policy changes to mitigate its impact.

Identify non-officers who may be newly discloseable

A particularly sensitive aspect of expanded disclosure will be the determination of up to three additional highly-paid employees who are not NEOs.[1]

Immediate Steps:

- Track compensation of non-officers with the potential to earn more than any of the NEOs on an ongoing basis, similar to the tracking already done for purposes of determining NEOs.
- Make potentially discloseable employees aware of the ramifications if their job descriptions and total compensation are reported.

Preview the New Disclosures

Test run the new proxy format

Mocking up a sample 2007 proxy is a good means to spot gaps in existing data collection or problematic issues in time to address them in advance of the new proxy season.

Immediate Steps:

- Draft the new "plain English" CD&A and tables, and schedule additional Compensation Committee meetings to review.
- Document the rationale for any decision to withhold performance measures and/or targets from the discussion of performance-based compensation.
- Draft the new Director Compensation Table and review with the Governance and Compensation Committees; consider drafting a CD&A discussion of the principles of director compensation.
- Provide data, on a preliminary basis, for each of the new tabular disclosures and draft associated narratives, possibly in lieu of or in conjunction with a "tally sheet" analysis.
- Focus on calculations and methodologies for determining amounts that will be more visible under the new rules, such as for perquisites and termination and change in control payment arrangements.

[1] While not finalized, we expect that this rule will be adopted substantially intact.

- Focus closely on whether perquisites are "integrally and directly related" to the performance of the NEO's responsibilities – if not, they will generally need to be disclosed if they confer a benefit to the NEO.
- Coordinate disclosure in the Summary Compensation Table with the financial reporting statement, as many of the calculations and disclosures required in this Table are based on calculations and disclosures for financial reporting purposes. Make sure you understand what these calculations and disclosures are before the financial statements are prepared (which is generally in advance of the proxy statement).

Fix problematic programs

Mocking up the CD&A narrative will help alert Directors to any disconnects between a company's stated compensation philosophy and the actual payouts provided. Timely review of the data and narratives also offers Compensation Committees an opportunity to identify any potential "hot button" compensation issues in advance, and to adopt appropriate program changes that can be reported in 2007 as part of the expanded disclosure.

Immediate Steps:

- Review newly reportable details of FAS 123R expense with accounting and finance areas, particularly:
  - Whether executive stock options are valued/reported separately from employee options.
  - What models and assumptions are used to determine grant date fair value for equity grants, especially performance-based stock awards.
- Check whether equity grants were issued on dates other than date of Board approval or with exercise prices different from the fair market value on the date of Board approval, both of which trigger additional disclosures under the new rules.
- Assess CIC and severance arrangements, including potential value and related tax gross-up obligations, and determine if payouts could produce what might be perceived as unreasonable liabilities to the company.
- Consider streamlining the number and variety of actuarial or defined benefit plans offered. This will help to simplify disclosure and avoid the costs of recalculating benefits from year to year and explaining shifts in benefit amounts that may occur for technical reasons, even when the overall benefit is unchanged.

Pearl Meyer & Partners has been on the forefront of preparing public companies and their Boards for the changes resulting from the final SEC disclosure requirements. Our Firm can assist in the timely development of high quality disclosure, including:

Tabular Disclosure Support

- Assist with the determination of NEOs.
- Provide a checklist of data needed and identify gaps.
- Provide an easy-to-use data request or obtain data directly from various service providers.
- Prepare the tabular disclosure.
- Advise on and/or prepare the new table narratives and footnotes.

CD&A and Narrative Disclosures Assistance

- Help with writing of the required narrative descriptions and underlying rationales for compensation programs, including objective and subjective bases for pay-for-performance plans.
- Advise on best practices in compensation governance, including equity grant practices.

Change-in-Control Calculations

- Perform detailed “Golden Parachute” calculations to establish values for all potential severance payments and related tax payments/deductions.
- Guidance on issues related to “Golden Parachute” payments that must be disclosed under the new rules, including gross-ups or scaleback provisions.

Monitoring of newly disclosed peer data

- Develop a template to track the expanded information available on peer and industry practices in new filings.
- Summarize the expanded peer data and contrast against current company practices.

Communications Issues

- Analyze internal and external communications challenges presented by new disclosure, including potential union concerns.
- Develop internal and external communications strategies.

Please contact us to discuss these recommendations or other compensation and governance issues at one of our seven offices listed on the reverse, or visit our Web site at www.pearlmeyer.com.

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