

ViewPoints

Assessing the 2007 SEC Comment Letters

Members of the Compensation Committee Leadership Network (CCLN) met in a series of two teleconferences in October and November to discuss the proxy comment letters the Securities and Exchange Commission (SEC) sent out in August and September. The teleconferences covered three primary topics: (1) what the SEC intended to accomplish with the letters and how well it succeeded; (2) members' observations and recommendations to the SEC; and (3) what we can expect in 2008 and beyond.

The following members participated in one of the two teleconferences:¹

- John Anderson, Hewitt Associates
- J. Thomas Bouchard, Manpower Inc.
- Michael J. Critelli, Eaton Corporation
- John T. Dillon, DuPont
- Thomas J. Donohue, Union Pacific
- Dina Dublon, Microsoft Corporation
- Bonnie Hill, The Home Depot
- Robert J. Lawless, Constellation Energy Group
- Michael Powers, Hewitt Associates
- Stephen W. Sanger, Wells Fargo
- Daniel H. Schulman, Symantec
- Samuel C. Scott III, Motorola
- Hugh W. Sloan, Manulife Financial
- Jonathan P. Ward, Sara Lee Corporation

Executive Summary

Members understand the “*generic concern to step back and put yourself in the layman’s view of the shareholder and ask, in plain English, why you did what you did.*” However, almost all members were critical of the SEC’s comment letters, saying that, in general, the letters conveyed a lack of understanding of business and executive compensation. Members wondered aloud about the selection criteria for who received a letter and ultimately agreed that there was no discernible reason for selection.

The request by the SEC for greater disclosure of performance targets troubled members deeply. They are extremely apprehensive about revealing what they believe to be confidential information. Members expressed frustration at the idea that there is an exact formula, or “*algorithm,*” for setting compensation, asserting that the compensation committee needs to “*strike a balance between formula and judgment.*” Members repeatedly emphasized the importance of maintaining judgment when it

¹ The compensation committee chairs are identified by their board membership.

comes to disclosure and protecting the candor that is necessary to deliberate over an effective compensation plan.

Members will work with management to achieve an incremental improvement in the 2008 proxies over 2007 but virtually no one plans to “start with a blank sheet of paper,” as John White, director of the SEC’s Division of Corporation Finance, has suggested. Instead, members largely agreed with the sentiment expressed by one of them: “We’ll make a few tweaks to our CD&A [in 2008,] but my real focus is on improving the overall plan.”

What Did the SEC Intend to Accomplish with the Letters, and How Did It Do?

SEC comment letters

In August 2007, the SEC began issuing comment letters on the 2007 proxy filings — more specifically, on the CD&A and tabular disclosures on executive compensation, corporate governance, and related disclosures.² About 300 letters were sent out in the first wave; a second wave of about 50 letters was sent out in September.³

How did the SEC decide which companies should receive a letter? Whatever the speculation in the press and online, the only criterion that appears consistent is size. One member offered: “My understanding is that [the SEC] wanted a cross-section of size and Fortune 250 companies, but there were definitely some smaller companies as well.” Another speculated that perhaps size played an even larger role than actual compensation disclosures: “I know of some very aggressive pay packages that didn’t even receive a letter . . . but it seems like size was sometimes more important than the actual CD&A.” In the end, members agreed that there was no discernible reason for the SEC’s choice of recipients.

The letters generally shared the same format: All were delivered via facsimile and were addressed directly to the chief executive officer. There was almost always a “boilerplate introduction consisting of four paragraphs that cover scope and process matters as well as the intent of the SEC in sending these letters, i.e., to assist in compliance and enhance overall disclosure in companies’ proxy filings.”⁴ The body of the letter generally requested additional information on or justification of performance targets and their confidential treatment, change-of-control agreements, benchmarks, the role of the CEO in setting compensation, services provided by compensation consultants, and other related issues. The comments were followed by boilerplate text identifying a response date, and the letter closed with the signature of an SEC attorney.

Members’ reactions to the letters

CCLN members understand that, at one level, the comment letters are meant to provide feedback, individually and collectively, so that the 2008 proxies will better conform to what the SEC believes shareholders need to know about executive compensation. However, many members question what

² Hewitt Associates, “Preliminary Overview of SEC Comment Letters on 2007 Proxy Filings and Suggested Process Steps for Impacted Companies,” *Executive Compensation Report*, August 24, 2007.

³ Broc Romanek and Dave Lynn, “Incoming! 2nd Wave of Executive Compensation Comment Letters,” *TheCorporateCounsel.net*, September 28, 2007, http://www.thecorporatecounsel.net/blog/archive/2007_09.html.

⁴ Mark Borges, “Second Wave of Comment Letters Issued,” *CompensationStandards.com*, September 30, 2007. Available to members at <http://www.compensationstandards.com/member/blogs/CompensationDisclosure/>.

the SEC's true intentions were with these letters. Their overall impression is that *"the letters seem to have accomplished very little."*

One of the primary frustrations for members is the fact that the letters often demonstrated naiveté on the agency's part. One member shared this appraisal of the process: *"My understanding is that basically the SEC used a number of relatively young interns to look over the disclosures, and therefore many of the letters showed a real lack of knowledge of business operations. . . I've heard of several companies [that] looked at the questions and thought someone had gone off the deep end because they were asking things about business operations that weren't appropriate."* Another member added: *"I know of someone who was asked in a letter, 'Why did you calculate this issue in this manner?' and the guy wrote back, 'Because you said in [the new regulations] to do it that way!' It was very clear that the people who wrote these letters were oftentimes either young interns or people who just don't know what they're talking about."*

One member asked: *"I'm just wondering, what are they objecting to? I thought the CD&As were pretty good this year. Where are they going with this, or is this just another exercise for them to grandstand and push back? What's their purpose?"* Another responded, saying, *"They want control. I absolutely believe that. They want to put a cap on compensation."*

The SEC's intentions aside, members agreed that *"the SEC underestimated the complexity of [its] plan designs. To describe particular metrics in the level of detail the SEC wants would be very problematic for some of these companies."* Another member added: *"I think they overplayed their hand with these letters, and I think they've figured that out. I just hope that when people write back, they don't give the SEC what they shouldn't."*

Still, despite their criticism and unanswered questions regarding the SEC's intentions, CCLN members acknowledge they will write their 2008 proxies with an eye to answering the questions raised in the 2007 comment letters.

Specific Observations and Recommendations to the SEC

Confidential treatment of performance targets

All of the comment letters members received or had seen asked for further explanation of the way performance targets and individual performance goals were set. One member said: *"It's my sense that it's mainly around this issue of performance objectives, the detailing of that and the rationale of the order around that."* Another member added: *"[Our letter] just asked for more on specific targets for individual performance goals."*

The SEC disclosure rules state that "companies are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm to the company."⁵ Yet the issue of confidentiality remains a concern. Several members believed they were justified in keeping their performance targets confidential, that the SEC

⁵ Securities and Exchange Commission, *Executive Compensation and Related Person Disclosure* (Washington, DC, 2006), 36. Available online at <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

had, in fact, requested information that could cause “competitive harm.” As one member put it: *“I think the big issue is not only how much you describe but also how you describe performance targets. Of all the feedback from the SEC, I think that’s been the most troubling. Whether it’s that they take it too far or that they just feel it’s unclear, there’s some concern that it might be too forward leading, some concern about how it might be used inappropriately by competition or misconstrued.”*

Members speculate that the SEC will likely be unhappy with some of the responses to its questions around performance metrics. Many members ultimately did not divulge that information to the SEC in their companies’ responses. Reported one: *“We had to ask ourselves, ‘How much can we reasonably disclose from a competitive standpoint?’ We ultimately decided not to disclose it because it is competitive information.”* Another member told the group that his company’s letter had asked for a complete qualitative and/or quantitative description of certain performance objectives, a request the company refused to honor: *“We won’t disclose that because it’s sensitive material!”*

Members were particularly reluctant to reveal the “math” that links performance metrics to pay. As one member pointed out: *“One part of it is ‘I don’t want to give you specific metrics because it’s sensitive information,’ and the other part of it is ‘I don’t want to give you the full formula.’”* Members believe that this will be one of the most crucial unresolved differences between compensation committee chairs and the SEC in 2008.

Need to balance formula and judgment

CCLN members agree that the task going forward will be to impress on the SEC the need to balance formula and judgment when it comes to compensation disclosure. Members are frustrated with the idea that it is possible to develop a simple formula that encapsulates a company’s compensation policy. As one member noted: *“One of the fundamental issues I have is with the whole notion that you just set a formula at the end of the year and don’t alter it. The reality is every year I’ve been a compensation committee chair, there’s always an issue of special items. . . . To get into the details of how and why you differ from the formula — I just wonder what you would say in a public filing that would satisfy them and yet not disclose your decision process to the public entirely.”*

Indeed, most members agree that flexibility and judgment are crucial to a compensation committee’s effectiveness. Said one seasoned compensation chair: *“I can’t think of a year we didn’t modify the numbers at the end of the year. I’d say it’s two-thirds judgment and one-third formula.”*

In response to concerns regarding increasingly heightened disclosure, members were quick to point out that if everything was already in the proxy, there would be no need for a committee: *“If you follow things directly how they want them to be, then you don’t even need a committee — you need bookkeepers! The whole point of having a committee is to deliberate and discuss.”* Keeping the ultimate objective in mind, another member noted: *“At some point you make a decision about how much you are/are not going to disclose, and if they want to have a discussion, then you do. You just want to give the shareholders an idea of the processes that are going on in their company.”*

The value of candor

One of the most provocative discussions during the teleconferences centered on the idea that a committee would change its compensation plan rather than reveal competitive information: *“If we truly are required to give out competitive data, then we are going to be forced to change the plan.”*

We'll change the plan before we give out information that would put the company at a competitive disadvantage."

Members pointed out a parallel with sunshine laws: Though crafted with good intentions, total disclosure would also have the unintended consequences of candor lost and posing taking precedence over progress: *"If you have everything out in the open, then candor suffers. I've watched in the years that I've been involved in public sessions, and the moment a reporter walks in the room, the conversation goes from candid and rich to formulaic and stilted. As soon as you require a compensation committee's reasons for doing something to be exposed fully in the proxy statement, then the level of candor and sophistication will go down markedly."*

Members agree that candor is an essential component of making effective compensation decisions. But, as one member pointed out, *"The SEC, Congress, they all understand the importance of candor by requiring executive sessions in the first place. They understand that if you want candor, you need to have private discussions, and here the SEC is asking us to disclose everything! There's a disconnect between the philosophy behind executive sessions and the idea that you've got to expose everything to the public."*

What Can We Expect to See in 2008 and Beyond?

On October 9, 2007, the same day that the SEC staff released its summary analysis of the 2007 compensation disclosures, John White gave a speech in San Francisco in which he offered the following advice for the 2008 proxy season: "Step back next year and start with a clean slate, a blank sheet of paper. . . . Before anyone starts drafting your CD&A. Ask every key participant (from the compensation committee chair on down) to turn in one page — no more than a page — perhaps even with the caption 'Analysis.' Hand them a copy of our just-issued staff report so that they see our concerns about missing analysis. Then ask for bullets. Those bullets should reflect what he or she sees, from their perspective, as the key 'hows' and 'whys.'"⁶

Members of the CCLN reacted strongly to White's suggestion: *"I think I would go back and say, 'What have I done so far that's wrong?' and address that rather than start from scratch. A clean sheet of paper means nothing to me. What do you want me to do? Rewrite all my compensation policies?"* Another member echoed that sentiment: *"We're not going to start over. We're not about to start with a plain sheet of paper."* Some members even asserted that following White's advice *"would probably make the process worse, not better."* The consensus was also that *"we'll learn a lot more as we hear what the SEC's response to the responses are."*

With their attention on the 2008 proxy disclosures, most members agreed with one compensation committee chair who said, *"We're going to do much of the same thing we did last year. We're going to look to management to bring us the data we need; we're going to consult with our lawyers; we'll bring in an outside guru to give us advice; and we're going to try and learn from last year without giving away the store. We'll see how it goes. We're going to refine our proxy, but we're not going to drastically change it."* Another member agreed, adding, *"We're just trying to plow ahead and think of some of these suggestions and get our product a little more on point. It's just a tedious process. We*

⁶ John W. White, "Where's the Analysis?" (speech, Tackling Your 2008 Compensation Disclosures: The 2nd Annual Proxy Disclosure Conference, San Francisco, October 9, 2007), <http://www.sec.gov/news/speech/2007/spch100907jww.htm>. The staff analysis is available online at <http://www.sec.gov/divisions/corpfin/guidance/excecompdisclosure.htm>.

pledged to our board that we are going to try and get this process shortened up so we'll tighten it up, use plain English, and try to make sure the 'hows' and 'whys' make sense."

Members believe it is important to remember that the CD&A is a management report despite the fact that the compensation committee is obliged to endorse it. Management almost always takes the lead, with the compensation committee's early advice and later review. As one member pointed out: *"This is not a committee report; this is a management report. On the other hand, the committee signs off on everything that goes into the proxy, so I guess it's one of the many things that goes on in a corporation."*

One compensation committee chair captured the group's thinking: *"The CD&A is a necessary evil we're all trying to comply with without disclosing too much and still passing muster. I'm much more interested in the plans we put in place that maintain and motivate top executives at our organizations."* Added another: *"I try to figure out how to improve the compensation plan itself, not necessarily the CD&A. I try to think about how we retain and attract the people that we want — that is my primary focus as the compensation committee chair. I figure if we have a good compensation plan and a good rationale, then I trust we'll be able to translate that into a document. We'll make a few tweaks to our compensation plan [in 2008,] but my real focus is on improving the overall plan."*

January Meeting in Washington

The next CCLN meeting will take place on January 9 and 10 in Washington, DC. Former SEC commissioner Roel Campos will join the group for a portion of the discussion and for dinner. CCLN members expressed universal support for engaging the SEC in a direct, face-to-face dialogue. Said one member: *"I think [Campos] will be an excellent speaker for us. I think his ideas will be provocative, and I will be very interested to see where he stands since he's left the SEC."*

About this document

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