

ViewPoints

Revising the SEC's Executive Compensation Disclosure Rules

Members of the Compensation Committee Leadership Network (CCLN) met in a series of three teleconferences on July 12, 23, and 26 to discuss possible improvements to the SEC's executive compensation disclosure rules. Members expanded these discussions to include lessons learned from the 2007 proxy season and the CCLN's role moving forward.

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

- J. Thomas Bouchard, Manpower
- Michael J. Critelli, Eaton Corporation
- John T. Dillon, DuPont
- Thomas J. Donohue, Union Pacific Corporation
- Dina Dublon, Microsoft Corporation
- Bonnie Hill, The Home Depot
- Robert J. Lawless, Constellation Energy Group
- Arthur C. Martinez, ABN AMRO and PepsiCo
- William A. Osborn, Caterpillar Inc.
- Victor A. Pelson, UPS
- Stephen W. Sanger, Wells Fargo
- Daniel H. Schulman, Symantec Corporation
- Samuel C. Scott, Motorola
- Hugh W. Sloan Jr., Manulife Financial
- Jonathan P. Ward, Sara Lee Corporation

The following members participated in pre-meeting discussions but were not able to take part in the teleconferences:

- Jerry D. Choate, Amgen
- A. Steven Crown, Hilton Hotels Corporation

Executive Summary

The three teleconferences covered two topics: 1) possible improvements to the SEC disclosure rules in light of the experience gained from filing the 2007 proxies; and 2) the value of the CCLN as a best practice sharing group. Members expressed a degree of surprise that very little actually happened as a result of the 2007 filings: e.g. no direct feedback from the SEC, very little shareholder activist reaction, no battles in the annual meetings, and a restrained response from the media. Some wondered aloud whether the best response to the SEC at this point might be no response at all.

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

Members agreed, however, that their proxies and the SEC's disclosure rules could be improved and members articulated several specific areas for improvement. Several members offered to speak in Washington on these matters, if a suitable forum could be arranged.

All members agreed that the CCLN is not and was never intended to be an advocacy organization – a role that groups like the U.S. Chamber of Commerce and Business Roundtable are far better equipped to play. The CCLN will continue to focus on best practices, helping members learn from one another's experiences to continually improve their own compensation committee work.

Proxy Disclosures and Modifications to the SEC Rules

2007 Proxies Created No Controversy

CCLN members observed that the 2007 proxy reports received less attention from the investor community and the media than some had predicted. Many members expected the 2007 proxies to come under intense scrutiny and criticism. This response never materialized.

As one member stated: *“The interesting thing, in my mind, was that there was minimal surprise by the investor community. I was surprised by the lack of ‘Oh, my God.’”* Another member concurred: *“I was surprised with the [lack of] follow-through from the activists who were trashing the compensation committees. . . . There were some reactions, but maybe the disclosures were enough for people to feel listened to and get their day in the sun. For example, at my own company, we had people ready to show up and make comments [at the annual meeting], but we ended up talking about the environment[, not compensation practices].”*

CCLN members contend that the proxies produced little reaction because, on the whole, they were thoughtfully crafted and executed. They also believe improvements in pay plans mitigated negative responses to this year's disclosures.

Although members feel that most of the changes in compensation plans were made in the years leading up to the SEC's new disclosure rules, they acknowledge that the rules did trigger some improvements. In particular, they described changes to perks, supplemental executive retirement plans (SERPs), tax gross-ups, and stock options. Said one member: *“We looked at perks. . . . We did away with tax gross-ups.”* Another member agreed: *“We recommended that the annoyances had to get taken out – for example, parking. And the one tremendous scrutiny is the SERP program.”* Another member added: *“We looked at perks and decided to stay with our perks. But we looked at options, restricted stock, and performance-based restricted stock, . . . and we made some changes in our options and restricted-stock programs.”* Members noted that some changes were made in the normal course of committee work. One member believes that the company's decision to eliminate perks was less a function of *“the new rules”* than the product of the *“continuing scan of best practices that we've been doing for years.”*

CCLN members disputed SEC Chairman Christopher Cox's characterization of the 2007 proxies as verbose and convoluted. One member challenged Cox's statement: *“I went through the CD&A three times editing it. I take exception to the idea that we don't read it and try to make it plain English. Most of us spend a good amount of time on this.”* Members also disagreed with the idea that proxies are full of “legalese”: Said one member: *“People spend a fair amount of time trying to make [the*

proxies] readable and straightforward.” And another insisted that “proxies did a much better job of maintaining plain English” this year than in years past.

Questions About the SEC’s Intentions and Basic Approach

During one of the teleconferences, a member persuasively questioned the SEC’s intentions with respect to disclosure: *“At a high level, there’s a desire to give investors the information they need to make an intelligent decision about how much companies are paying and committing to. But there seems to be a second intention as well, that emerged somewhere in the process – to embarrass executives by creating the highest possible single number for compensation and requiring every small item be disclosed.”* This information suggests that any input from CCLN members aimed at addressing the investor-information objective might conflict with the unspoken second objective and thus be ignored by the SEC.

But other members strongly rejected the suggestion that the SEC had any motive beyond improved disclosure. One member said: *“I think that’s ridiculous. That wasn’t the gist of [the SEC’s rules]. I think they were trying to get clarity around how the CEOs and named executives officers are paid and get more transparency into the process. . . . There was also a lot of shareholder unrest, and the SEC was responding to that.”*

Whatever its intentions, members agree that the SEC’s approach is decidedly rules based, not principles based. If members could change the SEC’s disclosure requirements, many would revamp its disclosure philosophy – substituting principles for rules. Members asked why the SEC does not simply pose a set of penetrating questions that cut to the heart of what investors want and need to know – questions virtually every compensation committee already focuses on and reports on to the board. Compensation committees, they suggest, could and would answer those questions directly and clearly.

Members were not sanguine that such a fundamental recommendation would have material impact. For this reason, many members are reluctant to ask for modification of what the SEC already has in place – fearing that any intervention would lead to even more rules being added to an already lengthy list of regulations.

Suggestions for Improvement

CCLN members acknowledge that their 2007 proxies were not perfect, and they are committed to continuously improving them. Admitted one member: *“Our [CD&A] was 29 pages long. There’s probably stuff in there that Cox didn’t expect.”* Some of these improvements would require rules changes initiated by the SEC; others can be implemented by compensation committees themselves.

- The contentious 11th-hour rule² needs modification to ensure that investors can easily match the award given in any year to performance in that year. Members were almost unanimous on this point. Said one: *“I think matching the performance period with the period paid would simplify [the disclosures] a lot.”* Another added: *“Awards granted in years of strong performance and exercised in bad years make people think we’re not paying for performance [when actually we are].”*

² On December 22, 2006, the SEC approved a last minute amendment to the disclosure requirements that allows companies to report equity awards annually rather than in the aggregate. See July 2007 *PreView* document entitled “Revising the SEC’s Compensation Disclosure Rules” for further information.

- Members feel they have done a good job of balancing their obligation to explain to investors how pay is linked to performance against the need to keep competitively sensitive performance metrics private. According to one member: *“The SEC should eliminate the requirement that we divulge specific goals for the performance targets.”* Another member explained that their company is happy to disclose that “customer satisfaction” is a key performance goal, for example, but would not disclose metrics or targets related to that goal. And another added: *“The purview of the board and the committee should be to determine which of these [key requirements] are competitive at any given time.”*
- Although many of the 2007 proxies were long, members assert that compliance with the SEC’s rules requires a lengthy document. *“After all,”* one member said, *“the SEC gave us a 370-page document and then complained that [it’s] getting too many words. That is part of the problem.”*
- Members would welcome clarification from the SEC on how best to comply with existing rules. In particular, they would welcome an SEC example of what it would like to see in change-in-control and termination agreements. Asked one member: *“Shouldn’t they give us a model? Particularly in terms of termination scenarios? You have no comparative basis when you look at different companies.”*
- Members also would like the SEC to provide examples of “unclear and lengthy legalese” excerpted from actual proxies and the same material rewritten clearly and concisely. Committees would then have concrete examples of what the SEC wants when it asks for clarity.
- Cutting to the core issue, some CCLN members suggest that the most effective way to simplify the language in compensation disclosures is to remove the threat of sanctions: *“If you want people to be more concise, eliminate the certification requirement and the threat of criminal sanctions. I’ve seen this countless times on a smaller scale: The more we tell people they’ll be on the hook, the more cautious they become, and the more [they] have to guard against everything.”*

The CCLN’s Role and Next Steps

Members called the question: *“Are we an advocacy or a best-practices group?”* In other words, should the CCLN try to influence the future direction of the SEC’s disclosure rules, or should the group content itself with serving as a forum for exchanging ideas and best practices?

Over the course of the three teleconferences, a consensus emerged: The CCLN is a best-practices group. Members conveyed a genuine appetite for learning from one another’s experiences and so improving the quality of proxy disclosures. They had little interest in attempting to influence policy or regulation. Said one member: *“I think we lose our real value if we become a lobbying group. [We] need to be thinking about how to help us do our jobs better.”* Responding to that comment, another member said: *“I agree with that. I don’t think we all have to have a common agenda where 20 or 25 people agree. We each have our own opinions and needs, but we are unified in figuring out best practices.”*

In the spirit of sharing best practices, we agreed to two next steps.

Collect and Synthesize Members' Lessons Learned and Best Practices

One member said: *"If we had each company submit a dos-and-don'ts list, I suspect there will be some thread of wisdom among all those responses."* Another added: *"I'd love to see people say where they feel they nailed their disclosure and to show us [their disclosure]. . . . This list would be drawn from CCLN members' own experiences."* One member predicted that this exercise would not only highlight new practices but also underscore the fundamental similarities among practices: *"I think you will find some common themes around how organizations are going about [writing the proxy statements], even across different industries."*

Members agreed to provide input for a best-practices document that will include their observations on the following:

- Recent changes to executive compensation plans: What are the most effective changes that your committee has made to the compensation plan? What changes did you consider and reject?
- Compensation disclosure: In which areas of the CD&A did your company most effectively communicate its compensation practices? What new or novel approaches did you employ in the CD&A? Which sections of your CD&A would you like to highlight for CCLN consideration?
- Other compensation committee best practices: What other committee practices would you like to discuss with the CCLN? Practices related to interactions with management? To your committee meetings? To succession planning and bench strength? To working with the full board? To compensating the next tier of executives?

Each CCLN member will contribute two or three specific examples within each topic area. These examples will be aggregated and provided to members in advance of the next CCLN meeting. Tapestry Networks will communicate with members separately to follow through on this task.

Ask the SEC for Guidance and Examples

Tapestry Networks will draft a letter to the SEC on behalf of the CCLN. This letter will initiate best practice sharing outside the CCLN. The letter will ask the commission to identify proxies that, in one member's words, *"got an A+ and why."* As one member said: *"The SEC could give us three examples of what [it] thought worked [from this past proxy season] and what didn't."* Another member clarified the form and content of the letter: *"We need a very simple letter: Here's who we are and what we seek to accomplish, and here are our specific questions or points of clarification. [We could say,] 'We'll take your guidance as an academic exercise,' so [the SEC doesn't] have to give an official answer."*

Fall Meeting in Washington

The next CCLN meeting will take place on October 18 and 19 in Washington, DC. We hope to invite an SEC commissioner to join the group for discussion and dinner. Our members were unanimous in their support of direct, face-to-face dialogue with the SEC. Said one: *"If we get the right people to the meeting in Washington with the group we have, it would be very beneficial."*

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