Executive Compensation Disclosure: A Roadmap

by Thomas P. Desmond, Ernest W. Torain, Jr., and Jason K. Zachary*

The SEC's interest in the area of executive compensation disclosure is evidenced by enforcement actions against The Walt Disney Company and General Electric Company, a settlement with Tyson Foods, and noteworthy comments from SEC Commissioners and staff. Each of these developments highlights how important it is for public companies to develop and maintain sound practices and processes to ensure full compliance with the SEC's executive compensation disclosure requirements.

Where Have We Been?

Although it may seem like the SEC's executive compensation disclosure requirements have been around forever, many of the prevailing rules are fairly new. Prior to 1992, executive compensation disclosure was primarily limited to an explanation of the amounts payable under compensation plans. Indeed, most of the required information was presented in narrative form, including a description of the material terms of any plan pursuant to which the compensation was payable.[1]

In October 1992, however, the SEC adopted extensive revisions to its rules governing the disclosure of executive compensation in proxy statements and other SEC filings. These revisions were designed primarily to give shareholders a more understandable presentation of the nature and extent of executive compensation. The revisions consolidated the requisite disclosure in a series of tables setting forth each compensatory element for a particular fiscal year; required a report by the compensation committee articulating the bases for their compensation decisions, including the relationship to corporate performance; and mandated a line graph comparing total shareholder returns of the company against those of a broad market index and a peer group. Even then, the SEC noted that the compensation committee report proposal "provoked the strongest comment of any of the proposals concerning executive compensation."[2]

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In August 1993, the SEC released a report[3] assessing compliance with the new executive compensation disclosure requirements. In addition to identifying common mistakes companies made in complying with the rules, the SEC also discussed shortcomings and strengths in typical compensation committee reports. Many of the common mistakes noted then, such as the failure to identify components of "All Other Compensation," incomplete reporting of supplemental executive retirement plan ("SERP") benefits, under-reporting of compensation in the summary compensation table, and lack of specificity in the compensation committee report, continue to be cited as deficient by the SEC even today.

Where Are We Now?

Item 402 of Regulation S-K governs the form and content of executive compensation disclosure. Among other things, Item 402 requires each public company to provide several tables comprising compensation information for the company's CEO and its four most highly compensated executive officers (other than the CEO).

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Item 402 also demands a compensation committee report with two principal components. First, the report must describe the committee's policies governing the prior year's compensation to executive officers and the specific relationship of corporate performance to that compensation. Second, the report must describe the committee's bases for the compensation reported for the CEO in the past year, including the criteria used to set the CEO's compensation and a specific discussion of the relationship of the company's performance to the CEO's compensation, with a description of each measure of the company's performance—qualitative or quantitative—on which the CEO's compensation is based.[4] As the SEC pointed out, the generality of the compensation committee report requirement is intended to accommodate the variety of policies and practices and measures of company performance that public companies use.[5]

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In October 2004, Allan Beller, director of the SEC's Division of Corporation Finance, noted that an important duty of board members is to properly motivate and reward management.[6] Director Beller offered guidance on how companies should approach disclosing executive compensation in SEC filings and how compensation committees can work to align executive compensation with shareholder interests. In connection with this guidance, the Director referred to a Blue Ribbon Commission Report that found that "'boards need to find better ways to measure and reward performance.'"[7] The Report also noted that the compensation committee must understand the numerous elements of executive compensation, the role each plays in motivating short-term and long-term performance, the cost of each element, and the total cost of the executive compensation program.

Director Beller also referred to the updated policy regarding executive compensation released by the Council of Institutional Investors. He focused specifically on the element of the policy regarding transparency:

> The compensation committee is responsible for ensuring that all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations. The compensation committee should disclose all information necessary for shareowners to understand how and how much executives are paid and how such pay fits within the overall pay structure of the company. It should provide annual proxy statement disclosure of the committee's compensation decisions with respect to salary, short-term incentive compensation, long-term incentive compensation and all other aspects of executive compensation, including the relative weights assigned to each component of total compensation.[8]

The Director indicated that executive compensation disclosure would improve if companies changed their outlook from one of "literal compliance" with SEC rules to one of seeking to provide disclosure of all compensation awarded to, earned by, or paid to the executive officers and directors covered in the proxy statement—whether it is paid currently or deferred. In other words, companies should be guided by the principle that *all* compensation must be disclosed.

Examples given of deficient disclosure include failing to report the personal use of company planes or cars and similar perquisites. Similarly, the Director noted that many companies are overly creative when categorizing perquisites as business expenses (e.g., items such as housing, security systems, and cars are commonly classified as business expenses). In his view, a helpful, though not dispositive, inquiry in resolving the business expense or perquisite issue is whether the benefit is available to employees generally on a non-discretionary basis, like reimbursement for a taxi across town for a meeting, or whether it is a benefit for which only a chosen few are eligible, like access to the corporate plane.

Finally, many companies would be well served by revisiting their compensation committee reports, which too frequently consist of boilerplate language that is substantially unchanged from year to year. The Director reminded his listeners of the requirements for the compensation committee report, and noted that disclosure in this area could be improved. For example, many companies set compensation in relation to a benchmark group without disclosing the basis for their compensation decisions or even whether compensation is linked to performance.[9] Instead, this analysis should include a consideration of each component of compensation as compared to the overall compensation package, providing a clearer basis for judging the reasonableness of the package.

Where Are We Going?

As noted previously, disclosure is required of all compensation, earned or paid, from all sources, for all services; there can be no material omissions that make the disclosure misleading. Commentators believe that compensation disclosure rule changes are on the way. The presumptive impact of these rules would be to make compensation disclosure more transparent by specifically capturing some of the compensation elements that have become prevalent since the current rules were adopted in 1992. Even if the SEC does not act, it is reasonable to expect that institutional investors will press for better, more complete, compensation disclosure.

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Director Beller noted several areas that may be the subject of SEC rule changes.[10]

Perk valuations. Some companies are inappropriately categorizing items as expenses instead of perks. In addition, companies need to review how they value perks and whether there are better approaches to valuation. In particular, the SEC may review whether incremental cost to the company is a useful measure that helps investors understand compensation.

Retirement benefits and deferred compensation. The SEC is reviewing its disclosure requirements, as well as companies' disclosure, related to SERPs and non-qualified deferred compensation plans.

Total compensation. The SEC is considering whether companies should be required to provide enhanced disclosure of total compensation.

Named executive officers. The SEC is considering whether companies should be required to disclose the compensation of other specific officers, such as the CFO and/or general counsel.

Director compensation. The SEC is looking at disclosure of overall director compensation to see if companies are following the current requirements, as well as whether their rules in this area should be expanded.

Compensation committee reports. The SEC is considering whether the disclosure requirements adequately address disclosure of the policies, operation, and determinations of the compensation committee. The SEC may consider whether the "not filed" treatment of compensation committee reports should continue. Director Beller suggested that the reports may not merit this special treatment because compensation committees have failed to use the reports to provide useful information.

Related-party disclosure. The SEC is considering the relationship between the executive compensation rules and the related-party transaction disclosure under Item 404 of Regulation S-K. Insofar as the related-party transaction rules relate to executive compensation, rulemaking in this area may be forthcoming.

What Should We Be Doing Now?

Comments from the SEC leave the clear impression that the agency considers executive compensation disclosure of many companies to be mediocre at best. While new rules are likely on the horizon, many companies would do well to consider the following.

Compensation committee reports

As previously mentioned, the executive compensation disclosure requirements have not changed much since the rules were adopted in 1992. However, as practice standards have developed, many companies "have followed a pattern of opaque or unhelpful disclosure…[t]oo much executive compensation disclosure has become an example of the kind of disclosure companies should disavow—disclosure that says as little as possible while seeking to avoid liability, rather than disclosure that seeks to inform."[11] Those are strong words, and a clear signal that business as usual in this area just will not do.

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Although the specific disclosure items discussed within each report may differ from company to company, there are several disclosure items that are applicable to companies of varying sizes; many of these items have begun to appear in proxy statements. For example, many companies are providing a detailed description of the process they used to reassess their executive compensation practices, including the retention of a consultant and comparisons with competitors and other similarly-situated companies. In addition, some companies offer a detailed discussion of the various factors considered by the compensation committee when awarding incentive compensation to executives, as well as an itemized list of the performance factors (and results) and each of the elements that were considered in setting the CEO's compensation. Finally, a conclusion that the total compensation paid to the CEO and other named executive officers was reasonable and not excessive has begun to appear in some reports to enhance a company's comprehensive discussion of its compensation philosophy and practices.

Best disclosure practices

Before starting to redraft compensation committee reports and other parts of the executive compensation disclosures, companies and committee members should have a thorough understanding of the information gathered for that purpose. In preparing the compensation committee report, members should consider the following questions, keeping in mind the actual deliberations of the committee:

- Does the report provide "clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers…and directors…for all services rendered in all capacities to the registrant and its subsidiaries…"?[12]
- Does the report disclose the nature of the group with which the compensation committee is comparing the company's compensation, why that group was selected, the extent to which the company differs from the benchmark group, and where in the range established by that comparison the company targets its compensation?
- If the amount or form of compensation awarded to named executive officers changed materially or significantly from the prior year, does the report explain what caused this change?
- Does the report detail the company's position regarding qualification of compensation for exemption from Section 162(m) of the Internal Revenue Code?
- Did the company adjust or amend the exercise price of stock options or SARs previously awarded to any of the named executive officers, whether through amendment, cancellation, or replacement grants, or any other means?

Compensation committee meetings

Since the compensation committee report is a reflection of how the committee discharges its duties, any anticipated update or expansion of the report in 2006 must start with a review of the committee's meeting practices in 2005 to ensure that they are sufficiently rigorous. Here are some questions to consider.

- Has a formal compensation philosophy been adopted that articulates the compensation committee's fundamental principles and that will guide the committee in developing and monitoring the company's executive compensation programs? These principles should reflect (1) independence of committee members; (2) pay packages that are perceived as fair—both internally and externally; (3) payments that are linked to realistic and achievable performance criteria; (4) incentives toward long-term shareholder value creation; and (5) full transparency regarding compensation plan design and implementation.

- Is the compensation committee looking at appropriate peer groups and benchmarks and scrutinizing the rationale for such references?
- Is the compensation committee aware of the perquisites and other personal benefits the company has provided to executive officers and directors?
- Has the compensation committee reviewed the amounts accrued for and ultimately payable to the executive officers under supplemental executive retirement plans and other retirement benefits and how those amounts are disclosed?
- What are, and how should the company disclose, the potential payouts to executive officers under severance and change-in-control arrangements under varying scenarios?
- Were all compensation arrangements tallied up and deemed not excessive?

Best meeting practices

Because good meeting practices often set the table for accurate and complete disclosures, we suggest that companies consider the following actions:

- Adopt a committee calendar for the full year to ensure that necessary topics are covered with adequate preparation time;
- If possible, have the compensation committee consider items twice: once for preliminary review and input and a second time for finalization and approval;
- Review the company's disclosure controls and procedures to determine whether they are adequate to enable the compensation committee to account for all compensation received by the executive officers and directors; and
- Use tally sheets or other summaries to understand the maximum compensation payable under multiple scenarios, including retirement, termination with or without cause, and severance in connection with a change in control of the company.

Final Thoughts

Executive compensation will continue to receive significant attention for the foreseeable future. In light of SEC commentary, activist institutional investors, and the threat of civil liability, the stakes are high for corporate board members. On the bright side, directors who are diligent, who devote adequate time and attention to the process, and who document their discussions are less likely to be subject to second guessing after the fact.

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Companies (and their counsel) should be leery of the "quick fix" for compensation disclosure. Sprucing up the disclosure without addressing any underlying functional deficiencies of the compensation committee (specifically in conducting or documenting meetings) is likely to make the situation worse from a shareholder relations perspective. In other words, do not over-promise and under-perform. Finally, remember that good disclosure practices start with good meeting practices.

1 Regulation S-K, Item 402 (as in effect for proxy statements and registration statements filed with the SEC before January 1, 1993).

2 SEC Release No. 33-6962 (Oct. 16, 1992), Section II.H.

3 SEC Release No. 33-7009 (Aug. 6, 1993).

4 Regulation S-K, Item 402(k).

5 SEC Release No. 33-7009, *supra* note 3, Section V.

6 "Remarks Before Conference of the NASPP, The Corporate Counsel and the Corporate Executive" (Oct. 20, 2004), *available at* <www.sec.gov/news/speech/spch102004alb.htm>.

7 *Id., quoting* Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee (2003).

8 *Id., quoting* The Counsel of Institutional Investors Corporate Governance Policies (updated Oct. 13, 2004), *available at* <www.cii.org/policies/compensation/role_comp_committee.htm>.

9 *See also* Chester Spatt, Speech by SEC Staff, "Executive Compensation and Contracting, Address at the Conference on Agency Problems and Conflicts of Interest in Financial Intermediaries" (Dec. 3, 2004), *available at* <www.sec.gov/news/speech/spch120304cs.htm> (noting that "'benchmarking' is often used [to set the compensation for senior management, including the CEO, by a compensation committee], though the approach does not seemed designed to produce a lot of effective information.")

10 *See* Remarks Before Conference of the NASPP, *supra* note 6.

11 *Id.*

12 *See* Item 402(a)(2) of Regulation S-K.