

# COMPLIANCE WEEK

## New Proxy Disclosure Best Practices Emerge

By Melissa Klein Aguilar — March 6, 2007

Executives who are planning to review the proxy statements of their peers this spring—to see how others are complying with the new rules for disclosure of executive compensation—should plan to give themselves a little extra time.

A look at the first batch of preliminary and final proxy statements that have trickled in to the Securities and Exchange Commission shows that, while the disclosure details vary widely from company to company, this year's filings all have one thing in common: volume.

“At face value, this year's proxies are clearly bigger and better,” says Alex Cwirko-Godycki, senior analyst at compensation research firm Equilar.

2007 marks the first proxy filings under the SEC's revamped compensation disclosure rules, including companies' first-ever Compensation Discussion & Analysis section. Modeled after the Management's Discussion and Analysis section in companies' periodic reports, the new principles-based CD&A calls for a detailed discussion and analysis of companies' compensation policies and decisions related to the separate elements of their programs and executive compensation as a whole.



Todd


While past compensation-committee reports were often 10 pages or less, Cwirko-Godycki says most of the CD&As filed so far are 20 pages or more. Likewise, Paula Todd, managing principal at compensation-consulting firm Towers Perrin, says the CD&A drafts she's reviewed have been “extraordinarily long,” with some reaching 25 pages.

Todd suspects that because the rules call for principles-based disclosure in some areas, “it's hard for people to get their arms around what exactly is intended,” she says. “I think we'll see [a] wide range of practices this year. This is new and people don't really know what they're supposed to do.”


In its adopting release for the compensation disclosure rules, the SEC outlined six broad questions companies should address in the CD&A section, as well as a number of illustrative questions and disclosures related to option grant practices. Some companies are trying to tackle the SEC's questions explicitly, by writing their CD&A specifically to those questions, Todd says. Others “have written something that looks like their compensation committee report on steroids, adding in the information to address the SEC's questions.”


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Borges

Mark Borges, a principal at Mercer Human resources consulting, thinks many of the 2007 proxy disclosures will be longer than they need to be. "A lot of companies are probably erring on the side of providing more information and detail, because they're not sure what's sufficient," he says. Borges is surprised that more companies aren't using more tables, charts and graphics to help illustrate their compensation policies or to summarize the information discussed in the CD&A.

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In drafting their CD&A sections, Borges says companies have struggled most with explaining the rationale behind their compensation decisions—"explaining the why," he says. "Most companies are very detailed in explaining what they're doing, but getting into the rationale and reasons behind their decisions is a new concept."

Companies also seem to be struggling with the required disclosure of performance measures. The preliminary proxy of MDU Resources Group is one example of how companies are tackling the performance metric disclosures under the new rules. The company was one of 12 early adopters cited as examples of key CD&A disclosure elements in a recent Equilar client alert.

MDU provided a detailed discussion of how its annual and long-term incentive targets were established by its compensation committee, and included a table with each named executive officer's 2006 base salary, annual incentive target, 2006 financial results as a percentage of planned results, and annual incentive earned for 2006.

"The table is good illustration for shareholders to get an easy grasp of the information," says Borges. "That's probably a good way to do it." (See the box above, right, for MDU's and other companies' disclosures).

Todd, who says none of the drafts she's seen have given as much detail as MDU, expects that many companies will shy away from disclosing their specific performance metrics. "Companies feel that some of their bonus goals shed a bright light on what their strategy is, and they consider that competitive information that they don't really want to divulge," she says. "Not all bonus plans are as formulaic as others, so companies can't always precisely explain them using a mathematical formula. There may be some judgment involved."

### More Disclosure Issues, Examples

Companies are also having a hard time with disclosures related to post-employment arrangements, Borges says. While companies are comfortable explaining their rationale for current compensation elements, "When they have to explain why they have retirement plans and severance and the like, the discussions seem to be tilted more toward the 'what' rather than the 'why.'"

#### CD&A

According to the Securities and Exchange Commission's adopting release regarding its rule, "Executive Compensation and Related Party Disclosure," here are examples of some of the issues that would potentially be appropriate for a company to address in the Compensation Discussion and Analysis section:

- Policies for allocating between long-term and currently paid out compensation;
- Policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- For long-term compensation, the basis for allocating compensation to each different form of award;
- How the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
- What specific items of corporate performance

“It’s a new concept,” he says. “People are still feeling their way through how to integrate it into the overall discussion.”

The Equilar report also cited pharmaceutical giant Merck & Co. for its disclosure of compensation philosophy. “We thought they used an interesting way to approach the disclosure about their compensation philosophy,” Cwirko-Godycki says. “The headings they use show at a high level what the company does, what they’re trying to achieve and how that affects the way they pay people.”

Another part of the proxy experts say is causing a lot of headaches for companies—and is likely to get a lot of attention from investors—is the disclosure of termination and change-in-control payments. While not included in the CD&A itself, Borges says those disclosures will be just as lengthy.

Since companies may have to consider a number of scenarios when estimating their post-employment payments, Cwirko-Godycki says several of the early adopter companies used tables for those disclosures. For example, the preliminary proxy of McDermott International includes individual tables showing multiple termination scenarios for each of its executives.

Doing so may help companies satisfy the requirement for plain English disclosure, Cwirko-Godycki adds. “Tables generally make things easier to read and allow companies to present a lot of information quickly,” he says.

Todd says McDermott’s tabular disclosure of the termination payments is reminiscent of the tally sheets companies prepare for the compensation committee.

“It’s what I call a user-friendly data dump,” she says. “I would guess that a lot of investors will applaud this, but I don’t think most companies will show this in that much detail.”

Meanwhile, Borges says there’s “room for improvement” in meeting the requirement that disclosures be made in plain English. In trying to make sure they have captured the precise details of how their programs work, he says, companies are still relying on jargon and technical terms in some cases.


are taken into account in setting compensation policies and making compensation decisions;

- How specific elements of compensation are structured and implemented to reflect these items of the company’s performance and the executive’s individual performance;
- The factors considered in decisions to increase or decrease compensation materially;
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits);
- The impact of accounting and tax treatments of a particular form of compensation;
- The company’s equity or other security ownership requirements or guidelines and any company policies regarding hedging the economic risk of such ownership;
- Whether the company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- The role of executive officers in the compensation process.

Please note that the Commission stressed that this list is not inclusive of all potential disclosures, and that “the application of a particular example must be tailored to the company and that the examples are non-exclusive.” The final rule also noted in several instances that the CD&A “should reflect the individual circumstances of a company and should avoid boilerplate disclosure.”

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#### Source

 SEC Final Rule: Executive Compensation and Related Party Disclosure (Published by the SEC Aug. 11, 2006)

“Companies are opting to make sure their disclosure is accurate, even if that makes the discussion a bit more complicated,” he says. “But it’s clear that people are trying to strike a balance.”

In addition to the 12 early adopter companies noted in the Equilar report, Borges points to the proxies of United Technologies and Allied Waste as examples of CD&A disclosures that do a good job explaining some of the particular elements of their programs.

Proxy disclosures mentioned in this article, as well as related resources and Compliance Week coverage, can be found in the box above, right.

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