
# RADFORD ALERT

## SEC Proposed Changes Seek to Enhance Visibility into Compensation Decision Processes

### SEC Also Stepping Up Review and Enforcement of Recently Filed CD&As; Joined by Governance Advocates on Key Pay Issue Changes

Continuing a multi-year effort to shed light into public company compensation program decision-making, the Security and Exchange Commission (SEC) has announced proposed amendments to its existing compensation disclosure rules. If adopted, these changes will go into effect in next year's proxy. These proposed changes are being announced as the SEC is stepping up its review of company CD&As, and enforcement of the controls set down in the CD&A regulations. This Radford Alert provides a brief overview of the proposed changes, as well as the issues the SEC is scrutinizing within recently filed CD&As.

**This revised reporting is intended to better illustrate the compensation executives actually received during the year**

**SEC's Proposed 2010 Changes**

On July 10, 2009, the SEC announced proposed changes to disclosure requirements in proxy filings, including revisions to the reporting of stock-based compensation in the Summary Compensation Table, new disclosures in the CD&A covering the connection between risk and compensation programs, and potential conflicts of interest related to the use of compensation consultants.

*Summary Compensation Table*

With respect to stock options and stock awards, the SEC has proposed that the reporting of stock options and stock-based awards be amended to replace the current disclosure of the dollar amount of stock and option awards recognized for financial reporting purposes with the FAS 123(R) grant date fair value of options and stock awards issued during the year. Finally, the new rules require the total compensation column be adjusted to reflect the sum of various elements of cash and non-equity compensation, including grant date fair value of awards issued during the year.

This revised reporting is intended to better illustrate the compensation executives actually received during the year and avoid some of the distortions of disclosing values recognized for financial reporting purposes (such as the possibility of negative values). With respect to the salary and bonus columns, the SEC proposed that cash compensation voluntarily foregone by executives as part of a program in which non-cash compensation is issued would no longer appear in the salary or bonus column, but rather in the appropriate alternative column in the Summary Compensation Table.

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*Compensation Policies and Company Risk*

The new CD&A section covering risk is clearly driven by the consensus that many large financial institutions in recent years took on unmanageable risks, and that this trend was attributable at least in part to incentive compensation policies that paid bonuses for achieving goals that created systemic, long-term risks to the company.

Specifically, the SEC has proposed a new section to the CD&A describing how a company's overall compensation/incentive policies and/or practices create employee incentives that affect the company risk's profile. For the first time, the application of this compensation-related disclosure policy extends beyond Named Executive Officers to include any employee where the company reasonably perceives a *material* risk relating to its compensation/incentive practices.

A non-exhaustive list of compensation-related policies and practices the SEC suggests might warrant a risk-related discussion include those of a business unit:

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- That carries a significant portion of the Company's risk profile
- With compensation structured significantly different from other units
- That is significantly more profitable than others
- Whose revenues make up a significant proportion of the Company's total revenues; and
- That differs significantly from the Company's overall risk/reward profile, such as where incentive compensation is paid upon achievement of a task whose benefits and risk will accrue to the company over an extended period of time

To the extent a material risk is identified, the proposed new CD&A section may discuss the company's general compensation philosophy, considerations of risk and incentives that factor into the structure of the compensation philosophy or actual compensation decisions, company policies to mitigate risk (such as clawback provisions or holding requirements relating to shares acquired via the exercise of stock options), and the Board's process for assessing and monitoring company risk related to the compensation program.

*Compensation Consultants*

Currently, companies must report the role of their compensation consultant in advising on executive and board compensation, as well as the part of the organization that has employed the consultant (management or the board). Under the proposed rule change, CD&As must include a discussion of services provided by the compensation consultant during the past year outside of executive and director compensation (e.g. benefits consulting, HR administration consulting, actuarial services, outsourcing). In addition, the CD&A must disclose the aggregate fees paid to the consultant for the additional services, and fees paid solely for executive and/or director compensation consulting.

Under the proposed rules, the CD&A should also discuss whether management played a role in selecting, screening or approving the hiring of the compensation consultant to perform the additional services, as well as whether the board approved the additional services.

As is the case with the proposed amendments to the Summary Compensation Table, these changes have been discussed for some time, and align with proposals advocated by many governance commentators.

The SEC has requested public comment on whether disclosure should include fees paid for "additional services" on an itemized basis or in aggregate. We believe it is likely that if the SEC's final rule proposes an itemized disclosure, there will be a minimum dollar threshold set for disclosure.

*Timing of Rule Adoption and Implementation*

A 60-day public comment period has been established for the proposed rules, and we expect finalization in 2009. If adopted, the rules will be in force in the 2010 proxy season. A copy of the proposed rules can be found at www.sec.gov/rules/proposed/shtml.

**Other Compensation and Governance Issues**

*Increased CD&A Review & Enforcement*

The SEC's proposed changes are being proposed against the backdrop of a recent increase in the level of SEC review and enforcement of CD&A disclosure rules. The SEC plans to increase the number of CD&As it reviews during 2010, and we expect will expand the scope of review to include any/all companies where they can illustrate a point. Specifically, the SEC is looking for companies to provide more details on the business rationale that drives their executive compensation programs rather than simply stating what the programs are and how they work.

Following up on similar reviews in 2008, the SEC will continue to push for greater granularity of detail about peer groups, peer selection criteria and performance targets used in the creation of compensation programs. While companies have steadily provided greater detail about their performance targets and metrics, the SEC is still looking for more. Ultimately, the agency wants to ensure that shareholders can draw a clear line between payouts made under incentive programs and the performance on which the payouts are purportedly based.

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If companies choose not to disclose the targets due to "competitive harm" they must provide a detailed explanation and discuss the degree of difficulty associated with disclosing the targets. The SEC has confirmed that this requirement is retrospective in nature, meaning that companies are not required to disclose their future year performance targets.

Executive severance and change-in-control provisions are also under continued scrutiny, with the SEC evaluating the company's explanation for why they provide given types of benefits, how they relate to a company's philosophy, and steps being taken to mitigate the program costs.

The SEC is not alone in its scrutiny of executive compensation practices, with executive tax gross-ups coming under particular pressure from investors (including proxy advisory firm RiskMetrics (formerly ISS). RiskMetrics (RMG) and institutions like Fidelity Investments have begun withholding votes from members of the Compensation Committee and even the entire board of companies that execute new employment contracts guaranteeing such payments, and at companies whose proxy disclosures include gross-ups paid on executive perquisites, however nominal in value.

Single-trigger equity acceleration provisions are also increasingly regarded as a "poor pay practice" that may cause RMG and others to take action against members of the board.

Finally, we understand that RMG is now recommending against the re-election of board members at any company that conducts an underwater option exchange/repricing without shareholder approval, regardless of the terms of the exchange program and whether the plan explicitly permitted the action.

*Say-on-Pay*

The tide is turning on Say-on-Pay, with proxy advisors, key congressional members and the US President all voicing strong support for the change. Currently, investors in US companies have no formal opportunity to be heard on a company's overall executive compensation philosophy/practice. Many governance organizations have proposed that companies adopt charter or bylaw provisions that require an annual vote on the totality of executive compensation programs.

Though non-binding, many institutional shareholders believe the vote would allow them to express their opinions of the executive compensation program and perhaps influence the board's thinking on future management pay issues. Similar voting rights currently exist in Australia, Netherlands, Norway, Sweden, Switzerland and the UK.

So far this year, investors at some 100 companies have asked for "Say-on-Pay." These companies include Coca-Cola, IBM, General Motors, Exxon Mobil, Citigroup, Anheuser-Busch, General Electric and Wal-Mart, and some companies (Intel, Verizon, Blockbuster and Par Pharmaceuticals, for example) have already adopted the policy.

It is widely expected that Say-on-Pay will continue to spread beyond the financial services arena, where the SEC has proposed it be mandatory for TARP participants, and may become majority practice in as little as one to two years.

We believe that several additional initiatives, both in the form of SEC rulemaking and developments in corporate governance, may combine to have significant impact on compensation in the next two-to-three years. In addition to those describe above, we are watching:

- **Majority Election of Directors**. Like Say-on-Pay, majority elections will potentially become standard practice in the near term, with many companies having already adopted a form of majority voting in response to investor pressure. Majority elections require directors receiving fewer "For" votes than "Withholds" to tender their resignation to the board.
- **Elimination of Broker-Voting in the Election of Directors**. The SEC has also voted to approve an NYSE proposal to eliminate the authority for brokers to vote shares for which they have received no instructions from the retail holders of a company's stock in favor of the re-election of directors. At companies with large proportions of retail shareholders, these "broker non-votes" can meaningfully influence the total vote.
- **Cumulative Effect**. The combination of majority vote requirements and the elimination of broker non-votes could create a growing number of "contested" elections, based significantly on dissatisfaction with a company's compensation practices.

**Conclusion**

The SEC's new proposed disclosure rules, combined with increased pressure from proxy advisors, investors and politicians, are signaling significant changes in how companies conceive, construct and publically communicate their executive compensation programs. We believe companies should prepare for the SEC rule changes by auditing their risk profiles and the role that incentive programs play in influencing how risk can materialize or be mitigated, as well as review their CD&A disclosure practices in preparation for the 2010 proxy season. Companies should also review their human resources and compensation consultant relationships to ensure a full understanding of the scope of their services, associated costs and the decision-making process used in the hiring of those consultants. We will follow the progress of the SEC's proposed rule changes and issue updates as warranted.

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