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The SEC Moves Forward with Executive Pay Proposals: Is It Enough?

A Word from the Publisher

We devote most of this issue to the SEC's recently proposed changes to the executive compensation disclosures. On pg 2, we examine the SEC's proposal that companies discuss, in the CD&A, how the company's compensation policies can affect its risks and management of those risks.

On pg 4, we discuss the SEC's proposal to return to disclosing equity awards in the Summary Compensation Table based on grant date fair value—a welcome relief for many of our readers. On pg 6, we look at the SEC's proposed disclosures relating to compensation consultants.

We have a number of thoughts on the SEC's proposals; we discuss the areas where the SEC is seeking comment and our thoughts on the proposals on pg 6. Moreover, we have included the full text of our comment letter to the SEC as a Special Supplement to this issue.

We conclude this issue with a look at how purchase limitations, often triggered in a down market, can impact P&L expense for ESPPs.

November Conferences

This issue is merely the tip of the iceberg when it comes to what our readers will need to know as they head into next year's proxy season. The "4th Annual Proxy Disclosure Conference" and the "6th Annual Executive Compensation Conference" in San Francisco in November will be absolute "musts" this year for anyone involved in the preparation of proxy disclosures or in designing executive compensation programs. See pg 11 of this issue (and the enclosed Conference Agenda) for the exciting line-up of speakers at these acclaimed Conferences.

Anyone attending either of the aforementioned Conferences will also want to stick around for the "17th Annual NASPP Conference." The practical guidance delivered at this Conference will be critical in our current uncertain economic climate.

—JMB

The SEC's Proposed Changes

The SEC has proposed changes to the executive compensation disclosure rules, seeking to expand the scope of the Compensation Discussion & Analysis (CD&A) disclosure requirement to solicit more information about the relationship between risk and compensation. Further, the SEC proposed to reverse its "December Surprise" and move back to the reporting of equity compensation awards in the Summary Compensation Table based on the grant date fair value of the award, as opposed to the current requirement to report the awards based on the amount expensed for the fiscal year in accordance with accounting principles. In addition to some broader corporate governance-oriented proposals, the SEC also proposed expanding disclosure about the role of compensation consultants—and the potential for conflicts of interest—through disclosure of fees.

Beyond these targeted proposals, the SEC solicits comment on other areas where the executive compensation rules could be changed. The proposed rules do not represent any significant rethinking of the requirements in light of the continued level of shareholder outrage over executive pay and don't address some of the lingering concerns with the 2006 revisions to the executive compensation disclosure rules. With comments due to the SEC in the very near future, it appears likely that, at a minimum, the proposed new rules for the CD&A and disclosure of equity awards in the Summary Compensation Table will be in place for next proxy season. It is critical that boards and their advisors act now in order to be prepared for these and other significant changes that appear to be on track for the 2010 proxy season.

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The Relationship of Compensation and Risk

The SEC's compensation disclosure rule proposals do not take place in a vacuum. In a June 10, 2009 statement announcing broad principles for pay reform, Treasury Secretary Timothy Geithner specifically identified executive compensation practices as a factor contributing to the financial crisis. Among the broad principles for pay reform identified by the Treasury Secretary (acting after consulting with SEC Chairman Mary Schapiro, Federal Reserve Governor Daniel Tarullo and a group of experts) were calls for a new "pay for performance" paradigm, structuring compensation to account for timing of risks, the alignment of compensation practices with sound risk management, and reexamining post-employment compensation and SERPs. (For an analysis of the Obama Administration's compensation principles, see our Summer 2009 issue of *Compensation Standards* at pg 2.) The SEC, in taking its own actions regarding executive pay, did not delve into all of these principles as they are reflected in the SEC's disclosure rules. Rather, the SEC chose to focus on the principles relating to the relationship between compensation (including compensation beyond the executive suite) and risk, and did not go further to propose rule changes revisiting areas that remain in need of attention, such as the disclosure and analysis of true "walk-away" amounts for post-employment compensation arrangements.

A Broader Scope to the CD&A (But Only When Material)

The principal focus of the rule proposals is on how a company's overall compensation policies may impact its risk profile. Since the enactment of Section 111 of the Emergency Economic Stabilization Act of 2008, there has been a spotlight on the relationship of compensation to risk, first at financial institutions, and then as applied to the broader realm of all public companies. In particular, the concern has been the extent to which compensation polices might result in creating incentives that cause executives (and others) to take unnecessary and excessive risks that potentially threaten the value of an organization. At our "3rd Annual Proxy Disclosure Conference," John White, former Director of the Division of Corporation Finance, asked the question: "Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target—with risk, in this case, being viewed in the context of the enterprise as a whole?" With these remarks, John White provided the first glimpse at how the SEC would view the relationship of risk with compensation policies and practices (see our November-December 2008 issue at pg 2), culminating in the recent rule proposals.

Interpreting the Current Rules Regarding Risk. Despite John White's statement and other indications of the level of interest that this topic engendered at the SEC and with investors, disclosure addressing the risk issue was not widespread (or, when present, was not fully developed) in CD&As during 2009. [For an analysis of some of the disclosures that were provided, see the Summer 2009 issue of *Proxy Disclosure Updates* at pg 7. For a model risk disclosure under the principles-based standards of the current rules, see the Winter 2009 issue of *Proxy Disclosure Updates* at pg 1.] This is likely to change for the 2010 proxy season, even if the current rule proposals are not effective by that time, given that the SEC made it clear in the proposing release that "[t]o the extent that such risk considerations are a material aspect of the company's compensation policies or decisions for named executive officers, the company is required to discuss them as part of the CD&A under the current rules."

A Materiality Threshold. Under the proposed amendments to the CD&A disclosure requirement, a company would need to discuss, when material, how the company's compensation policies, as a whole, can affect the company's risk and its management of risk. The SEC and its Staff have emphasized repeatedly that these proposals are not seeking additional disclosure when it is not needed; rather, the proposed rules would seek the disclosure when the risks arising from the compensation policies and overall compensation practices for employees "may have a material effect" on the company. While this materiality qualifier appears intended to limit the frequency with which the disclosure is required, it is hard to imagine the circumstances in which a company could conclude that a cash incentive compensation program or an equity compensation program does not have the potential to create some risks that may have

a material adverse effect on the company. In this regard, "pay for performance" in its very nature contemplates some level of risk-taking for most companies, given that employees will rarely be in a position to achieve real performance goals without creating some level of risk. In this way, it appears that the disclosure will be relatively universal (with the exception of companies that have limited incentive plans or have otherwise mitigated the risks), notwithstanding the materiality qualifier contemplated by the SEC.

Expanding the Scope of the CD&A. Today, CD&A is limited to discussion and analysis of a company's compensation policies and decisions regarding the named executive officers, and the CD&A is to relate specifically to the information disclosed in the compensation tables and otherwise disclosed pursuant to Item 402 of Regulation S-K. Under the SEC's proposals, the CD&A would potentially include discussion of company policies and decisions with respect to the compensation of named executive officers, other executive officers and non-executive officer employees. The proposals do not contemplate expanding all of the CD&A requirements to this larger group; rather, the policies and practices with respect to non-named executive officer employees would only need to be discussed in the context of how they relate to risk management practices and/or risk-taking incentives. However, in order to properly address the risk considerations, it may be necessary under the principles-based standards of the CD&A requirement to fully describe the relevant compensation policies and practices with respect to the non-named executive officer employees, so that the risk management and risk-taking elements may be put into proper perspective. Given these potential changes, companies will need to be prepared to publicly disclose a much wider range of compensation policies, programs and practices if these rules are ultimately adopted as proposed.

No New Tables Required. The proposed rule changes do not contemplate any additional disclosure about the compensation paid to employees in the organization as a whole; rather, the CD&A disclosure (if triggered) would focus strictly on policies and practices without getting into specific compensation levels for employees other than the named executive officers disclosed in the tables. In so doing, the SEC chose not to revive the so-called "Katie Couric" proposal to seek disclosure of the compensation paid to employees that exceeded the compensation paid to the highest paid executive officers, nor did it come up with an approach for reporting aggregate levels of compensation for covered employees. However, lacking specific compensation data, it may be difficult for investors to put the additional CD&A disclosure into perspective. As a result, it may be necessary for companies to provide some sort of relative quantitative disclosure about the compensation paid to a particular class of employees (*e.g.,* employees of a particular business unit) when discussing and analyzing the risk created by the applicable compensation policies and practices.

Triggering Circumstances for a Risk Discussion. The SEC's proposed changes to what is required in the CD&A do not spell out the types of risks that are contemplated. Companies (and their boards and compensation committees) will need to take steps to analyze all of the risks that may be created as a result of broadly-applicable compensation practices, and identify how those risks are considered and addressed. As contemplated by the proposal, the discussion of the relationship between compensation and risk may be required when, for example, compensation policies and practices involve:

- a business unit that carries a significant portion of the company's risk profile;
- a business unit with a significantly different compensation structure as compared to other units within the company;
- a business unit that is significantly more profitable than other business units within the company;
- a business unit where the compensation expense is a significant percentage of the business unit's revenues; or
- characteristics that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon the accomplishment of a particular task, while the income and risk to the company from the task extend over a much longer time period.

These potential triggering circumstances are by no means exclusive, and are designed to simply highlight the sort of circumstances that companies should be considering when examining the potential risks arising from compensation policies and practices. [*A Heads-Up.* For example, companies will want to focus on the encouragement of short-term risk taking inherent in stock options and restricted stock—and will need to address hold-through-retirement

provisions in their CD&A disclosure. (See the important discussion in the Summer 2009 issue of *Compensation Standards* at pg 4.)]

Principles for Disclosure. Similar to other aspects of the CD&A requirement, the proposed rule changes would not mandate specific disclosure that must be provided, but rather provide examples of issues that the company may need to address when talking about the relationship between compensation and risk with respect to the business unit or group of employees being discussed. For example, the proposed rule would note disclosure about the general design philosophy regarding compensation policies for employees whose behavior would be most affected by contemplated incentives as these policies relate to risk-taking, and the manner of implementation of this philosophy.

Further, a company may need to address the company's assessment of risk or incentive considerations (if any) when structuring compensation policies or when making awards or paying compensation, as well as the extent to which compensation policies relate to realization of risks resulting from employee actions in the short-term and long-term (for example, through clawback or holding period policies—see our November-December 2008 issue of *The Corporate Executive*).

The rule would also note the possibility for a discussion of the company's policies regarding adjustments to compensation policies or practices necessary to address changes in the company's risk profile, and the extent to which the company monitors compensation policies in order to determine whether the company's risk management objectives are being met with respect to employee incentives.

This proposed CD&A disclosure will be put into context by a broader disclosure requirement under the proposed rules that would require a company to describe the level of involvement of the board of directors in the risk management process, and the effect that the board's involvement has on the company's leadership structure. This new disclosure (which would be outside of the executive compensation disclosure) would need to include, for example, a discussion of how the board implements and manages the risk management function, whether those who oversee risk management report directly to the full board or to a committee of the board, and how the board (or the relevant board committee) monitors risk.

Where's the Analysis? As we have noted before (see our March-April 2009 Special Supplement of *The Corporate Executive* at pg 1), while Item 402(b) of Regulation S-K is labeled "Compensation Discussion and Analysis," the word "analysis" is used sparingly in the Item's explicit requirements. So too would be the case for the proposed new disclosure regarding risk, which as proposed would specifically require a company to "*discuss* the registrant's policies or practices of compensating its employees, including non-executive officers, as they relate to risk management practices and/or risk-taking incentives." While the proposed new paragraph goes on to make it clear that the purpose is to "provide investors material information concerning *how* the registrant compensates and incentivizes its employees that may create risk," it does not go on to call for the all-important "why" and specifically the analysis that the compensation committee has conducted in the course of examining the relevant approach and the attendant risk. Given the frustrating experience that the Staff had with implementing the CD&A requirement over the past few years, it may be appropriate for the SEC to make the proposed rule as clear as possible as to the need for analysis in this and all other parts of the CD&A.

Revisiting Equity Award Disclosure—Some Welcome Relief

The SEC's proposals would thankfully amend the reporting of stock and option awards in the Summary Compensation Table and the Director Compensation Table, by going back to the way the rules were originally adopted in the summer of 2006. As we noted in our March-April 2009 *Special Supplement* at pg 3, perhaps no other change contributed more to the complexity—and confusion—regarding the new executive compensation disclosures than the December 2006 amendments to the Summary Compensation Table and related disclosures that mandated presentation of the amounts expensed for equity awards instead of their grant date fair value. [In proposing this change, the SEC noted the discussion in the March-April 2009 issue of *The Corporate Counsel* (at pg 3).]

The Best Approach for Equity Awards? Under the proposed changes, the SEC would require disclosure in the Stock Awards and Option Awards columns of the fair value of equity awards on the grant date, as opposed to the cur-

rent disclosure requirement that is based on the expense recorded in the financial statements in accordance with FAS 123(R). While stating that "no one approach to disclosure of stock and option awards addresses all the issues regarding disclosure of equity compensation," the SEC is proposing to revert back to the original reporting method, and seems to be acknowledging that the grant date fair value approach "provides the most appropriate 'snapshot' for investors to evaluate prior period equity awards and, in turn, total compensation paid to executives in a given fiscal year." The SEC notes in the proposing release that if a company does not believe that the full grant date fair value reflects a named executive officer's compensation, then the company can provide appropriate narrative disclosure in order to address this consideration.

The change to a grant date fair value method would not necessarily do away with some anomalous results in reporting. For instance, the SEC solicits comments on the difficulties presented with reporting performance-based equity awards, which would be required to be disclosed at the full grant date fair value, even though amounts realized under the awards may be significantly different from the value shown in the Summary Compensation Table. Further, the SEC asks about whether the change back to grant date fair value may introduce variability into the named executive officers included in the table, particularly when executives get a single large grant that covers multiple years of service. While these are fair considerations that the SEC should take into account, we believe that the potential detriments are far outweighed by the clarity that could be achieved by switching to the grant date fair value method.

A Troublesome Result—And a Fix

As a result of the change in presentation of the value of stock awards and option awards in the Summary Compensation Table, the SEC proposes to amend Instruction 2 to the salary and bonus column of the Summary Compensation Table to indicate that a company will not have to report amounts of salary or bonus foregone at the election of the executive in the salary and bonus columns; rather, the non-cash awards received in lieu of salary or bonus will be reportable in the column that is applicable to the form of award that is elected.

We view this as troublesome, in that shareholders looking at the table will not be able to determine actual amounts of salary and bonus that were converted to stock or options. Shareholders are also entitled to see whether companies have implemented a laudable practice of converting bonuses into stock with long-term holding requirements. This is a positive disclosure that companies and shareholders should welcome. A responsible practice would be to require disclosure of the amounts of salary and bonus that were converted to equity awards, as well as the conversion ratio. Further, disclosure in the CD&A should provide the rationale for permitting/requiring the conversion of salary and bonus into stock or options. The SEC could address these concerns by requiring footnote disclosure of this information.

Dealing with Award Timing Issues. The SEC solicits comment on whether the Summary Compensation Table should reflect the aggregate grant date fair value of awards granted with respect to services in the relevant fiscal year (even if granted after the fiscal year), as opposed to limiting the disclosure to awards granted during the relevant fiscal year as contemplated in the proposed rule. A disquieting concern with the approach of reporting the value only of those awards actually occurring in the fiscal year is that it does not adequately take into account the extent to which compensation committees may only award the stock or options after the performance could be determined for the completed fiscal year in which services were rendered. This potential mismatch can lead to complicated efforts to explain compensation decisions in the CD&A, and can lead to the continued need for "alternative" Summary Compensation Tables which seek to reflect more closely the compensation committee's actions for a particular fiscal year.

Considering a Change in Value Approach. The SEC also solicits comment on whether it should alternatively consider adopting rule changes suggested in a May 2009 rulemaking petition submitted by Ira Kay and Steven Seelig of Watson Wyatt, which advocates that, instead of requiring the reporting of equity awards on the grant date fair value in the proposed method, the SEC consider requiring disclosure of the annual change in the value of equity awards, which could be positive or negative depending on the direction of the market. We view as more important the need for disclosure in the Outstanding Equity Awards Table of the accumulated value of all outstanding equity grants.

Transition Issues. The SEC indicates that it is considering requiring "modern" compensation numbers for the prior fiscal year included in the Summary Compensation Table as a means of increasing comparability of the equity award and total compensation amounts. The SEC indicates that it would not require different named executive officers based on the recomputed total compensation numbers for the prior periods. The SEC solicits comments on this proposed transition approach.

Compensation Consultant Disclosure: An Interim Step?

In our March-April 2009 Special Supplement (at pg. 7), we suggested that, among other things, the SEC require disclosure of fees received by a consultant when the consultant performs services for management and the compensation committee. Many concerns have been raised (including by the Obama Administration) about the role of compensation consultants in the compensation-setting process. Under the SEC's new proposal, companies would be required to include additional disclosures regarding compensation consultants hired by the company or its compensation committee.

More Fulsome Disclosure, Including Fees. The proposed rules would require that if a compensation consultant or its affiliates plays a role in determining the amount or form of compensation for the company's executives or directors, and also provides other services to the company, then the company must disclose:

- the nature and extent of the other services;
- the aggregate fees received by the consultant and its affiliates for determining or recommending the amount or form of executive and director compensation, and the aggregate fees for the other services;
- whether the decision to engage the compensation consultant for any other services was recommended or made by management; and
- whether the compensation committee or board approved the other services.

These proposed rule changes are reminiscent of disclosures required for auditors when the independence of auditors was being questioned in the late 1990s. And, like the auditor disclosure requirements, the SEC's proposals may not go far enough (at least in the eyes of some in the Administration, Congress and among investors) in addressing potential conflicts of interest arising from the use of compensation consultants.

Legislative Developments for Compensation Consultants. As part of the package of legislative proposals initially advanced by the Obama Administration and now part of a bill passed by the House entitled the "Corporate and Financial Institution Compensation Fairness Act of 2009," the SEC's proposed disclosure changes could be the tip of the iceberg for compensation committees and their relationship with compensation consultants.

The Corporate and Financial Institution Compensation Fairness Act would take a page out of the Sarbanes-Oxley Act's way of dealing with auditor independence by directing the SEC to mandate new listing standards of the national securities exchanges. These listing standards would require that compensation committees have the authority and funding to hire independent compensation consultants, outside counsel and other advisors. Under these standards, compensation committees would be directly responsible for the appointment, compensation, retention, and oversight of the work of the compensation consultants that they retain, and that the compensation consultants would report directly to the compensation committee. In addition, the bill would require the disclosure of whether the compensation committee had retained a compensation consultant satisfying required standards of independence established by the SEC. The SEC would also be tasked with conducting a study of the use of compensation consultants meeting required independence standards and the effects of the use of non-independent consultants.

Other Important Areas Where Comment is Solicited—And Our Comments

One of the striking things about the SEC's proposals is how little the agency is proposing to change in the face of such unprecedented public (and policy-maker) anger over executive compensation. We noted in our March-April 2009 *Special Supplement* (at pg. 7) that now is an ideal time to implement fixes to address weaknesses in the current disclosure rules (and non-compliance) given the significant attention toward executive compensation reform. Investors, Congress and others are focused on the need for clear and complete disclosure.

In the proposing release, the SEC does solicit comment (at pages 63-65 of the release, or pages 35092-3 of the Federal Register version), without proposing any specific changes to the rule language, on other potential changes to the executive compensation disclosure requirements, such as expanding the coverage of the rules to all executive officers (not just named executive officers), eliminating or revising the exclusion for the disclosure of performance targets measures, combining the CD&A with the Compensation Committee Report, requiring more disclosure concerning clawback, hold-until-retirement policies, gross-ups, compensation plans and internal pay equity, and disclosure about the expertise of compensation committee members.

We are attaching as a Special Supplement to this issue our comment letter highlighting what we view as the most important changes the SEC should adopt now.

Expanding the Scope of Item 402. As noted above, the SEC's proposed rule changes would only expand the CD&A to cover non-named executive officers in the context of how overall compensation policies and practices relate to risk management practices and/or risk-taking incentives, when material. In the proposing release, the SEC asks whether it should require disclosure of the compensation paid to each of the executive officers, not just the named executive officers as determined under Item 402. This approach may very well go too far, in that it may unduly complicate the executive compensation disclosure without providing much in the way of incremental disclosure relevant to how the company and the compensation committee approach compensation decisions and policies. Already, complaints abound about the length and complexity of the tables and the CD&A, and adding to that length may not be justified when sufficient information is already provided by looking strictly at the named executive officers.

Revisiting the Approach on Performance Targets. In our March-April 2009 Special Supplement (at pg. 3), we suggested that the SEC adopt an express requirement in the CD&A (and for the narrative disclosure accompanying the Summary Compensation Table under Item 402(e)) which mandates disclosure of performance target levels for completed periods, as well as a requirement to discuss current period or future period target levels, but only if material to an understanding of the discussion and analysis about the company's compensation policies and decisions for the last completed fiscal year. We suggested that this approach could be paired with retaining the competitive harm exclusion, provided that the exclusion would be adequately enforced and fully disclosed when used, coupled with disclosure of all circumstances about how difficult it will be for the executive or how likely it will be for the company to achieve the target levels. The SEC's proposing release opens the door to some further consideration of this topic, soliciting comment on "after the fact" performance target disclosure or, alternatively, elimination of the confidentiality exclusion entirely. We think that the compromise that we previously suggested might be a workable solution here, and provide a means for the SEC to address one of the most significant lingering concerns regarding the effectiveness of the CD&A in adequately explaining a company's "pay for performance" philosophy.

Retooling the Compensation Committee Report—And Director Accountability. The proposing release suggests several alternatives for retooling the Compensation Committee Report, which now serves only as a "furnished" short-form report of the compensation committee confirming its involvement in and recommendation for disclosure of the CD&A. The SEC asks whether the "furnished" versus "filed" status should be revisited or whether a combination with the CD&A is warranted.

One major reason for the lack of meaningful analysis in the CD&A is the absence of greater director accountability for the CD&A. The compromise position adopted in 2006 has not produced the analysis that was hailed to be "the cornerstone" of the 2006 amendments. This can be fixed by returning ownership—and accountability—of the CD&A to the compensation committee. We support making the CD&A and the compensation committee report one filed document.

Clawbacks and Hold-to-Retirement. The SEC notes in the proposing release that "some investors want more information regarding whether compensation arrangements are reasonably designed to create incentives for the executives to increase long-term enterprise value." In furtherance of this goal, the SEC asks whether tabular or narrative disclosure should be enhanced to require disclosure about whether a company has

Internal Pay Equity.

Addressing Complexity.

Gross-Ups—and Section 162(m).

Walk-Away Disclosure and Analysis—A Heads Up

Although not mentioned in the proposing release, companies should not lose focus on the need to provide—and analyze—full walk-away numbers for the named executive officers and for the CEO in particular. As part of his June 10, 2009 statement on compensation principles, Treasury Secretary Geithner specifically singled out that "disclosures typically failed to make clear in a single place the total amount of 'walk-away' pay due a top executive, including severance, pensions, and deferred compensation." As we

addressed in our March-April 2009 *Special Supplement* and in the latest issue of *Compensation Standards* (at pg 6), principles-based disclosure should drive disclosure of true "walk-away" numbers in the post-employment compensation disclosure required by Item 402(j).

The true walk-away numbers should include not only unvested equity grants, but also previously exercised grants and projected future grants based on the assumption that they will be made on the same basis as the most recent award, as well as projections as to pension benefits (including benefits from supplemental plans). The SEC and institutional investors will undoubtedly be looking closely for such disclosure—and, more importantly, analysis and explanation in the CD&A of the "need" for safety net provisions that balloon such numbers and cushion bad decisions or performance.

Companies and compensation committees may well want to get ahead and start now revisiting plans in light of a walk-away analysis (particularly in light of Treasury's announced concern about walk-away numbers and the need to revisit severance and other safety net provisions). Knowing that the CD&A walk-away analysis will be expected, compensation committees may wish to consider correcting severance and post-retirement provisions that are no longer defensible.

A Model CD&A Walk-Away Paragraph. Because so many companies will be grappling with the CD&A full walk-away discussion and analysis, we will be providing in the upcoming issue of *Proxy Disclosure Updates* a model CD&A disclosure that David Lynn, former SEC Chief Counsel, is drafting now, which will be posted on CompensationDisclosure.com. To access this important issue, those that may not yet be subscribers are encouraged to take advantage of the enclosed no-risk trial or go to CompensationDisclosure.com.

Next Steps—Comments Due Soon!

The SEC has requested comments on the proposals by September 15, 2009. Given the timing of the comment deadline and the relatively limited nature of the proposed changes, it appears that the SEC could adopt these proposals (along with the related corporate governance proposals) in time for the 2010 proxy season. Companies and their compensation committees need to begin thinking now about the above disclosures and how they will be addressed. Given the potential for a new rule in place and the need for companies to address their CD&A analysis shortcomings, this is a topic that can no longer be ignored.

Are You Recognizing Too Much Expense for Your ESPP?

While we firmly believe that employee stock purchase plans are a great program in down markets (see our November-December 1998 issue at pg 1), one unfortunate side effect of declining stock prices is that the statutory limit on the number of shares employees can purchase, i.e., the $25,000 limitation under IRC Section 423(b)(8) and other limitations included in the plan can become a problem. A lower stock price means a lower purchase price, which in turn results in employees being able to purchase more shares, ultimately resulting in more employees being subject to these limitations.

For example, let's say that an offering with a six-month lookback and a 15% discount begins when the FMV is $25 per share. If the stock price increases during the offering, the purchase price will be $17 per share and the maximum number of shares employees can purchase under the $25,000 limitation is 1,000 ($25,000 divided by the $25 FMV at the start of the offering). If the plan limits contributions to 10% of salary (a fairly typical provision), only employees earning in excess of $340,000 per year would be in danger of exceeding the $25,000 limitation, and only if they contributed the maximum that the plan allows. (The aggregate purchase price of 1,000 shares would be $17,000. For employees to be able to contribute enough funds to purchase this many shares, they would need to earn $170,000 over the six-month offering period.) There probably aren't that many employees earning this level of compensation—and those that do earn this are most likely executives, which we recommend that companies exclude from the ESPP anyway.

On the other hand, if the stock price declines during the purchase, say to $12 per share on the purchase date, any employees earning more than $200,000 per year could find that their purchases are subject to the $25,000 limitation. The purchase price would be $10.20 per share, resulting in an aggregate price of $10,200 for 1,000 shares. (Despite the decline in price, the shares are still valued at the $25 FMV from the

beginning of the offering for purposes of the $25,000 limitation and employees are still limited to purchasing no more than 1,000 shares. At this price, employees contributing 15% of their compensation only need to earn $102,000 over the six-month offering period to purchase the maximum allowed under the statutory limit.

You might scoff that this steep a decline isn't likely over a six-month period, but we suspect that there are a number of companies that would beg to differ. And despite the dire predictions about the impact of FAS 123(R), there are companies that still provide for longer offering periods, e.g., 12 or 24 months, where a decline of this magnitude wouldn't be that steep.

Limits Reduce Employee Returns

We have previously touted the virtually "guaranteed" 17.65% return that ESPPs offer to employees (see our November-December 1998 issue at pg. 1), but this is a situation where employees won't realize that return. Let's revisit our example above in which the FMV declines to $18 on the purchase date and assume that an employee contributed $16,100 to the offering. The employee will be limited by the $25,000 limitation and thus purchases only 1,000 shares, receiving a refund of $800 without interest. The employee contributed $16,100 and received stock worth $18,000, a return of only 12%.

If the employee had realized that the purchase would be limited, the smart thing to do would have been to not contribute any funds in excess of $15,300. This would have enabled the employee to allocate the $800 that otherwise would not earn any return to another investment. This is a good argument for allowing employees to reduce their contributions to $0 without withdrawing from the plan (see our January-February 2009 issue at pg. 3).

This is also a good reason for the plan to prohibit contributions in excess of $21,250 (85% of $25,000), since that is the maximum purchase price permitted under the $25,000 limitation. Ideally this limitation should be applied on an annual basis, although enforcement may be complicated for a plan with six-month offerings. One workaround would be to limit contributions to each six-month offering to $10,625 ($21,250 divided by two). But, in a rising market, this works to employees' disadvantage. Let's say that a six-month offering (with a lookback and 15% discount) begins on January 1 when the FMV is $15 per share (resulting in a purchase price of $12.75 if the FMV increases by the purchase date). At the start of the subsequent offering, the FMV has appreciated to $30 per share, resulting in a purchase price of $25.50. In this scenario, employees are better off purchasing as much stock as possible in the first offering; limiting contributions to $10,625 per offering forces employees to divide their purchases between the two offerings, ultimately paying more for the stock they purchase over the one-year period.

Warning Employees About Limits. A best practice here would be for companies to monitor employees' progress towards the $25,000 limitation or any plan limits and warn employees when it appears that they will be subject to these limitations. To our knowledge, there's no easy way to do this. Since the number of shares employees will purchase is dependent on an unknown—where the purchase price ends up—the only way to do this is to estimate how many shares employees will purchase based on their levels of contributions, their compensation and the current stock price. This is obviously an estimate and should be communicated as such. If it should turn out that the stock price recovers before the end of the offering, then fewer employees will be subject to the limitations. But, at least with this notification, employees can make an informed choice about their contribution level and there should be fewer unpleasant surprises on the purchase date.

Accounting Considerations

We had assumed that the refunds resulting from employees being subject to these limitations would be treated as forfeitures and the company would go back and adjust the amount of expense recognized for the fewer number of shares that employees purchased. But, it turns out, this isn't the case. Instead, the possibility of employees being subject to a statutory or plan limitation should be taken into account when estimating the initial fair value of the plan.

Where an ESPP includes a lookback and a discount, and doesn't limit the number of shares employees can purchase based on the price at the beginning of the offering (this type of limit prevents employees from purchasing additional shares when the price declines and guarantees that employees won't realize a 17.65% return in a down market), the ESPP fair value includes three components: (i) the discount as of the offering beginning, (ii) a proportionate amount of an

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[illegible]

[illegible]

[illegible]

Introducing the Monte Carlo Simulation. [illegible]

[illegible]

[illegible]

[illegible]

Worth the Trouble? [illegible]

[illegible]

Treasury's Mark Iwry to Speak at 6th Annual Executive Compensation Conference

We're very excited to announce our speakers for the "6th Annual Executive Compensation Conference" that will be held at the San Francisco Hilton and via Live Nationwide Video Webcast on November 10th.

The All-Star cast includes:

- Treasury's Mark Iwry, Senior Advisor to Secretary Geithner
- RiskMetrics' Pat McGurn and Martha Carter
- NY Times' columnist Joe Nocera
- Noted counsel John Olson and Marc Trevino
- Renowned consultants Fred Cook, Ira Kay, Mike Kesner, Doug Friske, James Kim and Don Delves
- Panel of respected Directors
- Investor advocates Ed Durkin, Meredith Miller and Paul Hodgson

Now that Congress is moving on say-on-pay (and other compensation-changing initiatives), you need to register now to attend our critical conferences and get prepared for a wild proxy season. Remember that the "6th Annual Executive Compensation Conference" is paired with the "4th Annual Proxy Disclosure Conference" (held on November 9th)—so you automatically get to attend both Conferences for the price of one. See the enclosed or visit TheCorporateCounsel.net to view the agenda for both Conferences.

A Heads Up. We are experiencing a rush of sign ups for the Live Nationwide Video Webcast. No doubt due to the recognition that the SEC's new proxy disclosure rules (and say-on-pay) will be impacting several different people and departments, more companies and law firms have been taking advantage of the special firmwide rates like never before. We mention this now as a heads up to make sure that your company, your firm (and your client companies) are signed up. Please use the enclosed form that has the special Live Nationwide Video Webcast rates.

Proxy Disclosure Updates—Full Walkaway Model CD&A

As mentioned at pg 9 within, David Lynn, former SEC Chief Counsel, is right now putting the final touches on a key, new model CD&A disclosure which will need to be addressed in this year's proxy statements. The upcoming special issue of *Proxy Disclosure Updates,* David Lynn's and Mark Borges's electronic newsletter, that is part of Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" will focus on this important new full walkaway disclosure, providing not only their new model disclosure, but also invaluable guidance on what to cover and why and how.

To access this critical model disclosure and guidance, any readers who may not yet be subscribers to Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" are encouraged to take advantage of the no-risk trial, which entitles you to the rest of this year free. To take advantage of this special offer—and to gain immediate access to the upcoming issue of *Proxy Disclosure Updates*—we encourage you to return the enclosed form, or go to CompensationDisclosure.com and gain immediate access. [Note that all subscriptions to the Annual Service are on a September year, so current members will need to make sure your renewals are in to ensure that you will have immediate access to the upcoming special issue.]

The New 2010 Edition of Lynn, Borges & Romanek's "Executive Compensation Disclosure Treatise & Reporting Guide"

Mark Borges and David Lynn are right now completing the 2010 version of "The Executive Compensation Disclosure Treatise & Reporting Guide," addressing everything you will need to comply with the SEC's new executive compensation rules—including the impact (and ramifications) of the newest rule changes on all upcoming proxy statements. This comprehensive, practical body of work—over 1,000 pages—is chock full of explanations, annotated sample disclosures, analysis of situations that you may find yourself in, and more.

The Treatise, together with the invaluable *Proxy Disclosure Updates* newsletter, is part of Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" on CompensationDisclosure.com. By purchasing one, you get both. The 2010 Treatise will be posted online as soon the final edits are made and mailed as soon as it is printed in early October—so you will have it in hand as a critical guide to refer to during this upcoming, challenging proxy season. [Note again, that because all subscriptions to the Treatise and Annual Service expire in September, it is time to renew your subscription to Lynn, Borges & Romanek's "Compensation Disclosure Annual Service" now to ensure that you receive the Treatise and gain immediate access to the online version on CompensationDisclosure.com—as well as the upcoming special issue of the *Proxy Disclosure Updates* newsletter.]

We encourage all our readers who have not yet discovered the Treatise and Annual Service to try a no-risk trial—now. Please use the enclosed form to receive a $100 or more discount.

Romeo & Dye's Forms and Filing Handbook

We are pleased to announce that Peter Romeo and Alan Dye's fully revised "Section 16 Forms and Filings Handbook" has now been published and mailed. It includes a number of new—and critical—model forms. To receive this "must have" resource, try a no-risk trial to "Romeo & Dye's Section 16 Annual Service" by going to the upper right corner of the Section16.net home page, or call (925) 685-5111.

The Year for *The Corporate Executive*

With the year ahead shaping up to be the most eventful and challenging in decades, *The Corporate Executive,* with David Lynn's critical insights and guidance, will be more invaluable than ever. We are truly grateful for the kind words we have been receiving these days not only from long-time subscribers, but also from many new subscribers. It appears that we have struck a chord with many more departments within corporations (from legal, to HR, to Investor Relations), and many more lawyers within law firms.

In recognition of the need we are serving this year, in particular (and in view of the tight economic times), we are extending a special offer for new subscribers which will enable anyone to receive *The Corporate Executive* at no risk. We encourage you, our loyal readers, to bring *The Corporate Executive* to the attention of friends and colleagues who might benefit from the newsletter in the challenging days ahead. In these challenging times, this is the one newsletter you cannot afford to be without.

Renewal Time

Renewal time is upon us. Please return the enclosed renewal form to ensure that your subscription does not lapse.

—JMB/DL/BB

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