“Tackling Your 2009 Compensation Disclosures: The 3rd Annual Proxy Disclosure Conference”

Course Materials

Note these course materials – among others – are also available online, as well as a video archive of the entire conference.

October 21, 2008

TheCorporateCounsel.net and CompensationStandards.com

Coming Soon! A critical CompensationStandards.com series of webcasts — "*The Latest Developments*: Your Upcoming Proxy Disclosures - What You Need to Do Now!" – via Nationwide Webcast - on January 21st and 28th. These webcasts will be a “bring down” from today’s Conference as we get into the proxy season.

You can attend this Conference at no charge if you are a 2009 member of CompensationStandards.com! Renew your membership when you return to your office and mark your calendar!

// THE CORPORATE EXECUTIVE

PUBLISHER: JESSE M. BRILL P.O. Box 3895, San Francisco, CA 94119

THE NEWSLETTER FOR THOSE THAT ADVISE PUBLIC COMPANIES

Vol. XXII, No. 1 *January-February 2008*

The Latest Proxy Disclosure Guidance

Note: Because of the heightened need for proxy disclosure guidance during the critical days and months ahead, David Lynn, former SEC Chief Counsel, will be writing the lead piece in each issue of *The Corporate Executive* this coming year, providing the latest compensation disclosure guidance and pitfalls.

—JMB

"Best Practice" Disclosures for Your Compensation Discussion and Analysis

In response to requests from so many of our readers, we are providing examples of "best practice" disclosures that seek to address areas of concern raised by the Staff in its review of executive compensation disclosures. These hypothetical examples are based on the latest Staff guidance, including the guidance provided in the Staff's "Observations in the Review of Executive Compensation Disclosure" and John White's "Where's the Analysis?" speech at our "2nd Annual Executive Compensation Disclosure Conference." (For detailed analysis and guidance on the Staff's comment letters, see our September-October 2007 issue; for a discussion of John White's speech and other notable takeaways from the Conferences, see our November-December 2007 issue and see the Fall-Winter 2007 Supplement to *Compensation Standards*.)

While there is no "one-size-fits-all" approach to providing the required level of analysis in your CD&A, the following examples should provide the necessary framework for improving your disclosure in order to address the Staff's concerns and to provide more useful disclosure for your shareholders. As we have noted in the past (and as John White referred to in his speech), these disclosures may be best highlighted in a separately-captioned "Analysis" section of the CD&A.

The key to providing the analytic disclosure that the SEC expects is to have the appropriate analytic tools in place when compensation decisions are made. Without the necessary analytic tools, an issuer does not have (1) a framework for providing a complete discussion of the factors relevant to the analysis, (2) the findings that emerge from the analysis, or (3) the resulting actions that the company has taken in light of the analysis. (Note that these three aspects of the analysis that the Staff will be looking for were the bulleted items that John White listed in the closing of his speech.) Also critical to the development of better analytic disclosure is the establishment of disclosure controls and procedures which ensure that the compensation committee's deliberations and internal analyses are captured in a way that will facilitate the "analysis" disclosure that is expected in the CD&A.

[Note that the examples provided below address aspects of compensation (such as severance) where a growing consensus of consultants and defenders of CEO pay are calling on companies to perform the critical analysis—and deal with unanticipated amounts and outcomes that may no longer be appropriate.]

Focus on Total Compensation and Use of Tally Sheets

The foundation for any analysis in the CD&A needs to be a focus on the named executive officers' total compensation. For this purpose, the total compensation figure is typically not going to be the one reported in the Summary Compensation Table—rather, it is going to be based on internal assessments of executive pay (typically using a "tally sheet") that give the compensation committee a complete picture of the total compensation awarded, the target compensation that could be awarded, realized, unrealized

recycled paper

Copyright © 2008 The Corporate Executive Publishing Co.

ISSN 1535-962X

and projected equity gains and total accrued equity gains and wealth accumulation under termination and change-in-control scenarios.

The SEC expects a company to describe its compensation committee's analysis of this information and how it influences the committee's pay decisions.

Best Practice Disclosure:

Tally Sheets:
Our Focus on Total Compensation

When making compensation decisions, the Compensation Committee analyzes tally sheets prepared for each of the named executive officers. These tally sheets were prepared by our human resources department and our compensation consultant. Each of these tally sheets presents the dollar amount of each component of the named executive officers' compensation, including current cash compensation (base salary and bonus), accumulated deferred compensation balances, outstanding equity awards, retirement benefits, perquisites and any other compensation.

These tally sheets reflect the annual compensation for the named executive officers (both target and actual), as well as the potential payments under selected performance scenarios and termination of employment and change-in-control scenarios. With regard to the performance scenarios, the tally sheets demonstrate the amounts of compensation that would be payable under minimum, target and maximum payouts under our cash and equity incentive compensation plans. For the value of termination of employment and change-in-control payments, the amounts are determined under each of the potential termination or change-in-control scenarios that are contemplated in the named executive officers' employment agreements and under our equity compensation plans.

The overall purpose of these tally sheets is to bring together, in one place, all of the elements of actual and potential future compensation of our named executive officers, as well as information about wealth accumulation (discussed in more detail in the "Our Review and Analysis of the Need for Termination and Change-in-Control Arrangements" section of this Compensation Discussion & Analysis), so that the Compensation Committee may analyze both the individual elements of compensation (including the compensation mix) as well as the aggregate total amount of actual and projected compensation.

In its most recent review of tally sheets, the Compensation Committee determined that annual compensation amounts for our CEO and the other named executive officers remained consistent with the Compensation Committee's expectations, however it also decided that the compensation mix for our CEO needs to be adjusted on a going-forward basis.

With respect to our CEO's compensation, the Compensation Committee noted that approximately 35 percent of his overall annual compensation was derived from base salary and cash incentive payments under our annual and long-term cash incentive plans. The Committee decided that the appropriate target for cash compensation to the CEO, considering in particular the unrealized appreciation in his outstanding equity awards, should be adjusted to 45 percent of overall annual compensation. As a result, the Committee decided to decrease the number of performance-based restricted stock unit grants, while increasing the targets and the target award opportunity for the long-term cash incentive plan.

The Compensation Committee utilizes the tally sheet information in all other aspects of its analysis and compensation decision-making process. As described throughout this Compensation Discussion & Analysis, the Committee bases its analysis on the tally sheet information in consideration of the management team's internal pay equity and in decisions regarding termination of employment and change-in-control arrangements. In fact, after factoring in

continued …

wealth accumulation as part of our tally sheet analyses, the Committee concluded that adjustments were needed to termination of employment and other post-employment provisions. See our discussion below under "Our Review and Analysis of the Need for Termination and Change-in-Control Arrangements."

Compensation for Individual NEOs and Internal Pay Equity

One of the most common Staff comments was a request that the issuer make the CD&A sufficiently precise so as to identify material differences in compensation policies and decisions for individual named executive officers. These comments focused on the relative levels of compensation and how their internal pay relationship is evaluated in setting those levels of compensation.

Note that when analyzing internal pay equity, it is important that compensation committees factor in those areas where there has been the greatest divergence in internal pay equity over the last several years—equity awards and post-employment benefits. If the analysis reveals that equity awards and post-employment benefits have gotten out of line, then action is needed to adjust the compensation going forward. The Best Practice Disclosure set forth at the end of this section (on page 5, below) provides an example of how this situation could be handled.

Best Practice Disclosure:

Internal Pay Equity At Our Company

Our core compensation philosophy is to pay our executive officers competitive levels of compensation that best reflect their individual responsibilities and contributions to the Company, while providing incentives to achieve our business and financial objectives. While comparisons to compensation levels at companies in our peer group (discussed below) is helpful in assessing the overall competitiveness of our compensation program, we believe that our executive compensation program also must be internally consistent and equitable in order for the Company to achieve our corporate objectives as outlined at the beginning of this Compensation Discussion and Analysis.

In implementing this philosophy, the Compensation Committee has analyzed a study of the relationship between our CEO's total compensation and the total compensation of the other executive officers of the Company over the past 20 years. For this purpose, total compensation includes not only base salary and bonus payouts, but also the grant date fair value of equity awards (as well as factoring in accumulated realized and unrealized equity gains—including one-time awards), all perquisites and projected post-retirement benefits and severance amounts.

Our human resources department conducted the internal pay equity study under the direction of the Compensation Committee. This study demonstrated that while there have been variations in the level of CEO compensation relative to the compensation of other executive officers over the past 20 years, the CEO's compensation was on average two times greater than the median compensation of the named executive officers and four times the median total compensation level for the next lower tier of management. In addition, the study demonstrated that _____ percent of the aggregate compensation to all of our named executive officers was paid to the CEO.

The Compensation Committee evaluated the mix of the individual elements of compensation paid to the CEO and the other executive officers over the course of the period covered by the internal pay equity study, as well as the changes in the overall composition of the management team and the overall accountabilities of the individual executive officers and the CEO. The study included and the Compensation Committee considered and factored in the special annual

continued ...

equity awards made to the CEO in his first three years of employment with the Company, as well as his potential post-employment payments, benefits and perquisites. The Committee also analyzed the change in the responsibilities of the management team over the measurement period, including the increase in the number of executive officers and the CEO's efforts to flatten the management organizational structure and remove redundant and wasteful management layers through increased individual accountabilities for the most senior executive officers, who are typically the named executive officers for the purposes of this disclosure.

Based on this analysis, the Compensation Committee determined that the target level of total compensation for the CEO should not exceed two times the median total compensation for the named executive officers. In addition, the total compensation for the CEO should not exceed four times the median total compensation level for the next lower tier of management. The Compensation Committee determined that the average results yielded from the internal pay equity study reflected an appropriate target differential for executive compensation, given the different accountabilities for the CEO and the other named executive officers. [This analysis also contributed to the Compensation Committee's decision regarding the executive officers' termination of employment, change-in-control and retirement provisions covered at pgs 7-9 below.]

To implement this decision, in 2007, the Compensation Committee determined that the CEO's base salary should remain fixed at $800,000, and exercised its discretion (see "Negative Discretion" later in this Compensation Discussion and Analysis) to reduce the CEO's payout under our annual cash incentive plan from $2.0 million to $1.8 million, in both cases as a means of maintaining the CEO's compensation in line with our internal pay equity policy while considering the other elements of the CEO's 2007 compensation discussed elsewhere in this Compensation Discussion and Analysis.

Under this policy, the Committee also considers the internal pay equity among the other executive officers—and in relation to the next lower tier of management—in order to maintain compensation levels that are consistent with the individual contributions and responsibilities of those executive officers. At the same time, the Committee increased the COO's base salary from $600,000 to $700,000, based on her individual contributions in reducing costs under the Company's previously announced program and her recent assumption of responsibility for European operations. [*Editor's Note:* Include additional discussion of the individual consideration of the other named executive officers, if material.]

Best Practice Disclosure if Internal Pay Equity Needs to be Adjusted:

Our Internal Pay Equity Analysis—Resulting Changes

Based on its analysis of results derived from the internal pay equity study and an analysis of the total value of wealth accumulated—particularly the amount of realized, unrealized and projected equity gains—by the CEO and the other named executive officers, the Compensation Committee has decided to reassess the need for continued annual equity awards, as well as whether the CEO's and some of the named executive officers' post-retirement and severance benefits should be scaled-back. As a result of this reassessment, the Committee believes that the current "carried interest" of our top most senior executive officers provides a major incentive and that there would be little incremental incentive value to continue to provide further annual restricted stock awards. In addition, the CEO volunteered not to receive further stock option or restricted stock awards since his current stock ownership could be worth over $25 - $50 million based on the company's and the CEO's expected performance over the next five years.

The Committee will also limit awards of restricted stock and restricted stock units for other purposes, except as they are used as a retention device by converting cash bonuses into

continued ...

restricted stock and restricted stock unit awards. Further, as described in more detail in the section entitled "Our Review and Analysis of the Need for Termination and Change-in-Control Arrangements," the Committee has decided to phase out termination of employment and change-in-control arrangements. The Committee will also offset and phase out the overall benefits under supplemental executive retirement arrangements, given the substantial amounts available to the named executive officers for post-retirement purposes with their accumulated equity awards and deferred compensation account balances.

The Compensation Committee believes that these adjustments, made in recognition of the individual named executive officers' circumstances, will reduce the divergence in internal pay equity and thereby restore the proper balance in the compensation for our senior management team.

[*Editor's Note:* These Best Practice Disclosures represent one approach for an internal pay equity analysis. Another valid approach would be to focus on determining internal pay differentials that are only supported by differential work and value–added contributions to the management structure at each pay level. This analysis goes hand-in-hand with overall organizational analysis that examines whether there is wasteful and unnecessary over-layering of management. For more information on this approach, see our "Internal Pay Equity Methodologies" Practice Area on CompensationStandards.com.]

Benchmarking

The Staff's comments on benchmarking disclosure focus on how issuers used comparative compensation information when making executive compensation decisions and how that information affected compensation decisions. The Staff has raised questions about the composition of peer groups, the nature and extent of any discretion used in the benchmarking process, and the targeted percentiles (collectively and for individual compensation) that were used in the benchmarking analysis.

As we noted in our September-October issue of *The Corporate Counsel* (at pg 2), the real issue is too much reliance on benchmarking and not enough attention to meaningful analysis. If an issuer only (or mostly) relies on benchmarking in setting executive compensation, then the Best Practice Disclosure that follows is not possible—rather, for a company that benchmarks externally but does not also do an internal pay equity comparison and analysis, this material analytic fact should be disclosed in the benchmarking discussion and analysis.

Best Practice Disclosure:

Benchmarking Against Peer Companies

When making compensation decisions, we also look at the compensation of our CEO and the other named executive officers relative to the compensation paid to similarly-situated executives at companies that we consider to be our peers—this is often referred to as "benchmarking." We believe, however, that a benchmark should be just that—a point of reference for measurement—but not the determinative factor for our executives' compensation. The purpose of the comparison is not to supplant the analyses of internal pay equity, wealth accumulation and the individual performance of the executive officers that we consider when making compensation decisions.

Because the comparative compensation information is just one of the several analytic tools that are used in setting executive compensation, the Compensation Committee has discretion in determining the nature and extent of its use. Further, given the limitations associated with comparative pay information for setting individual executive compensation, including the difficulty of assessing and comparing wealth accumulation through equity gains and post-employment amounts, the Committee may elect to not use the comparative compensation information at all in the course of making compensation decisions.

continued …

The Compensation Committee established our current peer group of companies in 2005. With the assistance of our compensation consultant, the Committee reviews the composition of the peer group annually to ensure that companies are relevant for comparative purposes. The Committee replaced two of the companies comprising the peer group in 2007. We believe that the group of companies is representative of the sector in which we operate, and the group was chosen because of each of the companies' relative leadership position in our sector, their relative size as measured by market capitalization and the relative complexity of the business and the CEO's role and responsibilities. Our peer group consists of the following companies:

[*Editor's Note:* Include a specific list of the peer group companies, identified by name, as well as an analysis of the comparison between the CEO's and named executive officers' total compensation and the total compensation figures—with performance comparisons—for the peer group, listing all elements included as well as all elements that were not included.]

Performance-Based Compensation

With the bulk of executive compensation typically oriented toward performance-based pay, it is certainly no surprise that much of the Staff's focus has been on disclosure concerning performance-based compensation and the disclosure of performance target levels used to determine performance-based pay. Currently, the Staff is considering issuers' arguments as to why the disclosure of performance target levels may cause competitive harm, so it remains to be seen what arguments will support the withholding of these target levels. Many of the Staff's second-round letters request a detailed analysis justifying the decision to omit performance targets, including a specific discussion of how the disclosure of performance metrics may affect business decisions of competitors. When possible, material performance target levels should be disclosed in order to facilitate the analysis in the CD&A. Many CD&As this past year were woefully inadequate in describing and analyzing the degree of difficulty and the likelihood of meeting the targets, etc.

The Staff also expects issuers to fully describe how they use performance targets and how they consider individual performance in the course of making compensation decisions.

Because this disclosure is so specific to the issuer, we are not, at this time, providing an example of best practice disclosure, but, instead we refer readers to the following examples: Dell, Dupont, Intel—and see Mark Borges's invaluable, ongoing proxy disclosure blogs on CompensationStandards.com.

Use of Discretion for the Annual Incentive Plan

The Staff has raised comments requesting more detail (and, in particular, analysis) concerning the scope and actual use of discretion in setting performance-based compensation. The following only covers "negative discretion," which many companies will need to address this year.

Best Practice Disclosure:

Negative Discretion

The Compensation Committee exercises "negative discretion" in setting payouts under the annual incentive plan. By setting a high amount which can then be reduced, we are advised by legal counsel that our annual incentive plan meets the requirements of Section 162(m) of the Internal Revenue Code. In 2007, the Compensation Committee exercised its negative discretion to reduce the payout to the CEO from $2.0 million to $1.8 million.

This reduction was not a negative reflection on the CEO's performance as he, in fact, performed beyond our actual target expectations. If the Compensation Committee were to have discretion over the bonus amounts, those amounts would not qualify for the Section 162(m) tax deduction.

continued …

As a result, while performance targets are utilized in setting compensation under this plan, ultimately the level of those targets and the Compensation Committee's use of negative discretion typically results in the award of compensation as if the annual incentive plan were operating as a discretionary plan.

Termination and Change-in-Control Arrangements: The Importance of a Wealth Accumulation Analysis and Walk-Away Numbers

In many instances, the Staff has requested a more thorough discussion and analysis of termination of employment and change-in-control arrangements. In particular, the Staff expects an analysis of whether—and how—the company factored in other elements of compensation in determining such provisions. In essence, the Staff expects the CD&A to include a complete analysis of the "why" behind the termination and change-in-control arrangements.

A critical aspect of the compensation committee's analysis of these arrangements is a consideration of the wealth accumulation of the CEO and the named executive officers. The wealth accumulation numbers are necessary so that the compensation committee can truly analyze whether the CEO or the named executive officers need the protection afforded by these arrangements. In many instances, upon critically examining the level of wealth accumulated by an executive officer, the compensation committee may determine that the level of post-employment payments and benefits are unnecessary and not consistent with the company's overall compensation philosophy or policies.

As noted in some of the Staff's comments and underscored by respected compensation consultants (see the discussion of Ira Kay's and Mike Kesner's remarks in our November-December issue, at pg 3), a total "walk-away" number for each scenario is important disclosure for investors. It also demonstrates that the compensation committee considered and understood the full extent of the numbers—including all realized and unrealized equity gains.

Best Practice Disclosure:

Our Review and Analysis of the Need for Termination and Change-in-Control Arrangements

Under the terms of our equity-based compensation plans and our employment agreements, the CEO and the other named executive officers are entitled to payments and benefits upon the occurrence of specified events including termination of employment (with and without cause) and upon a change-in-control of the Company. The specific terms of these arrangements, as well as an estimate of the compensation that would have been payable had they been triggered as of fiscal year-end, are described in detail in the section entitled "Termination and Change-in-Control Arrangements" on page __, below.

In the case of each employment agreement, the terms of these arrangements were set through the course of arms-length negotiations with each of the named executive officers. As part of these negotiations, the Compensation Committee analyzed the terms of the same or similar arrangements for comparable executives employed by some companies in our peer group. This approach was used by the Compensation Committee in setting the amounts payable and the triggering events under the arrangements.

The termination of employment provisions of the employment agreements were entered into in order to address competitive concerns when the named executive officers were recruited, by providing those individuals with a fixed amount of compensation that would offset the potential risk of leaving their prior employer or foregoing other opportunities in order to join the Company. At the time of entering into these arrangements, the Compensation Committee

continued …

considered the aggregate potential obligations of the Company in the context of the desirability of hiring the individual and the expected compensation upon joining us.

Our 2007 Review. In 2007, the Committee analyzed and reassessed all of the termination and change-in-control arrangements to determine whether they are necessary and appropriate under the Company's current circumstances and given the circumstances of the individual named executive officers. The Committee will continue to review these arrangements annually.

In conducting this analysis, the Committee reviewed the wealth accumulation numbers included in the tally sheets (as described above), as well as the aggregate value of all compensation that would result in the event of each triggering event under the termination and change-in-control arrangements. We refer to these amounts as the total "walk-away" number under the relevant arrangement. The following table shows the "walk-away" number for each of the named executive officers:

[*Editor's Note:* Include a table summarizing "walk-away" numbers under each triggering event under the termination and change-in-control arrangements, as well as any necessary explanatory disclosure regarding underlying assumptions and any potential differences from numbers presented in the termination and change-in-control disclosures required under Item 402(j) of Regulation S-K. See our model walk-away tables at the "Severance Arrangements" Practice Area on CompensationStandards.com.]

In analyzing the continued necessity of these payments and their relative cost to us, the Compensation Committee compared the total "walk-away" amounts to the value of the wealth accumulated by each of the named executive officers. The following table summarizes the total accumulated wealth values as of the end of the fiscal year and projected values over the next five years and ten years for each of the named executive officers:

[*Editor's Note:* Include a table summarizing, for each named executive officer, the aggregate realized and unrealized value of previously granted and projected equity awards, deferred compensation balances, pension amounts, supplemental retirement benefits and other accumulated compensation elements, along with disclosure of the relevant assumptions.]

The Compensation Committee determined that each of the named executive officers has accumulated sufficient wealth so that the termination of employment provisions, including severance payments and accelerated vesting, no longer served their original purpose. In addition, it was recognized that such payments are not incentive or performance related. The CEO voluntarily chose to give up his rights to any such payments in recognition of the wealth he has or will have accumulated. We are pleased to report that all of our other named executive officers stepped forth and did the same, with the exception that our CFO, who just joined the company one year ago, agreed to sunset her severance provisions after three years. As a result, effective January 1, 2008, the severance provisions of our employment agreements with the named executive officers were eliminated. The Compensation Committee also adopted a policy that for any new executive hire—to the extent that severance is necessary—the severance provisions will "sunset" after a period of three years of employment.

With respect to the change-in-control provisions, the Compensation Committee examined the relative costs of these arrangements in light of the expected benefit in the event of a change in control transaction, and determined that the benefits that would be derived are not worth the attendant costs in foreseeable merger or acquisition situations. As a result of this analysis, the Compensation Committee decided to take several steps that will be accomplished by the end of the second quarter of 2008:

- Our equity-based compensation plans will be amended to replace the current "single trigger" acceleration of all unvested equity awards at the date of the change of control with a "double trigger" provision whereby awards will not be accelerated unless the executive officer is terminated or in the event that the acquiring company does not assume or replace the outstanding equity awards; and

continued …

- Considering our obligations in the event of a change-in-control to pay gross-ups on excise taxes under Section 280G of the Internal Revenue Code, those provisions will be eliminated from the change-in-control provisions of the executive officers' employment agreements.

Overall, the Compensation Committee determined that these changes to the employment agreements and our equity compensation plans would not adversely affect our shareholders' interests in the event of a change-in-control of the Company—or necessarily increase the potential for an unwanted takeover—while reducing the potential costs and rationalizing the benefits in light of the overall level of wealth collectively accumulated by our named executive officers.

Retirement, Pensions and SERPs

The Compensation Committee is in the process of conducting a similar "need" analysis with respect to the current pension and SERP benefits for the CEO and the other named executive officers.

Perquisites

While the Staff did not focus on perquisites in its review program (although it did raise particular questions about perquisite allowances), this element of compensation continues to raise concerns about the justification for the benefits and the way in which costs are calculated. As with other elements of compensation, the CD&A must address the "why" behind the perquisites—and the "how" with respect to determining the costs of the perquisites. The disclosure needs to demonstrate that the compensation committee has an understanding of what is provided to management and how much it is costing the company.

Best Practice Disclosure:

Reassessment of Our Perquisites

We have provided our CEO and the other named executive officers with several perquisites, including personal use of company aircraft and automobiles and company-paid financial planning services. We also provided our CEO with a country club membership under the terms of his employment agreement, and we have agreed to continue his perquisites for a period of three years following his retirement and certain other termination events.

We have provided perquisites as a means of providing additional compensation to the CEO and the named executive officers, through the availability of benefits that are convenient for the executives to use when faced with the demands of their positions. However, in light of the current levels of compensation for our CEO and other named executive officers, during 2007 the Compensation Committee reviewed its policies regarding the availability of perquisites going forward, eliminated most of the perquisites that the Company historically provided, and imposed limits on the remaining perquisites. As a result of these changes, beginning in 2008 our CEO will be limited to 30 hours of personal use of corporate aircraft and our president and executive vice presidents each will be limited to the lesser of two round trips or twenty hours of personal use. No other executive officers will be permitted personal use, except under unusual circumstances.

The Committee intends to review the Company's policies with respect to perquisites on a regular basis and to consider whether, and to what extent, it may be appropriate for the CEO

continued …

and the other named executive officers to reimburse the Company for perquisites, including personal use of corporate aircraft.

The amounts reported for perquisites represent the incremental cost—and not the total cost—of providing the benefit and not the value of the benefit to the recipient. With respect to the personal use of corporate aircraft, we have computed incremental cost on a per hour basis for each aircraft by including:

- the cost of fuel, oil and catering expenses;
- landing, parking, flight planning, customs and similar fees;
- the cost of maintenance (including inspections and overhauls);
- "dead head" costs of flying planes to and from locations for personal use; and
- the dollar value of the lost tax deductions for expenses that exceed the amounts reported as income for our CEO and the other named executive officers.

Since our aircraft is used over 95% for business travel, incremental costs exclude fixed costs such as depreciation, crew compensation, hangar rent, and insurance. Where spouses or other guests accompany an executive on a flight, applicable catering costs are allocated to the executive as well. In 2007, our CEO used corporate aircraft for personal use for an aggregate of 37 hours at an average incremental cost of $4,950 per hour, and our COO used corporate aircraft for personal use for an aggregate of 26 hours at an average incremental cost of $3,800 per hour. The cost of leasing a comparable jet at comparable times would have been approximately $6,450 per hour.

Accounting and Tax Implications

One area where the Staff's expectations were not fully communicated through the comment process or the Staff Report is with respect to disclosure about the accounting and tax implications of compensation policies and decisions. The CD&A needs to address more than just the implications—and the actual outcomes—of complying with Internal Revenue Code Section 162(m); it must describe the actual tax and accounting consequences that were considered and taken into account by the compensation committee when setting and analyzing each aspect of the CEO's and the named executive officers' individual compensation.

Best Practice Disclosure:

Tax and Accounting Impact on Compensation

The financial reporting and income tax consequences to the Company of individual compensation elements are important considerations for the Compensation Committee when it is analyzing the overall level of compensation and the mix of compensation among individual elements. Overall, the Compensation Committee seeks to balance its objective of ensuring an effective compensation package for the named executive officers with the need to maximize the immediate deductibility of compensation—while ensuring an appropriate (and transparent) impact on reported earnings and other closely followed financial measures.

In making its compensation decisions, the Compensation Committee has considered that Internal Revenue Code Section 162(m) limits deductions for compensation paid in excess of $1 million. As a result, the Compensation Committee has designed much of the total compensation packages for the named executive officers to qualify for the exemption of "performance-based" compensation from the deductibility limit. However, the Compensation Committee does have the discretion to design and use compensation elements that may not

continued …

be deductible within Section 162(m), if the Committee considers the tax consequences and determines that nevertheless those elements are in our best interests.

In 2007, $_______ paid to the CEO and $_______ paid to the CFO, were not deductible. The Compensation Committee reviewed these amounts from a cost/benefit perspective and concluded that they were acceptable, but decided to avoid such payments in 2008.

We also found, as a result of an internal review of controls, that our performance restricted stock plan did not meet all of the requirements for deductibility under Section 162(m), resulting in a potential charge of $_______ impacting awards made to named executive officers. As stated above, the Compensation Committee does not intend to be making additional restricted stock grants to our named executive officers.

As stated in our description of the incremental costs for the personal use of company aircraft by our CEO, in 2007 we incurred $_________ in forgone tax deductions.

In addition, the change-in-control provisions described in the section entitled "Our Review and Analysis of the Need for Termination and Change-in-Control Arrangements" were originally designed to reduce the amounts payable that otherwise would have been subject to an excise tax known as "excess golden parachute payments" as defined under Internal Revenue Code Section 280G. Our arrangements with the named executive officers contemplate that we will gross-up the amount of tax due under this provision. As discussed above, the Compensation Committee, after conducting a cost/benefit analysis, has decided to eliminate the gross-up provisions from the named executive officers' change-in-control arrangements in 2008.

[For those companies that retain gross-up provisions, it will be necessary to show how costly they can be.]

Stock Ownership Requirements

While the Staff did not focus on stock ownership requirements in the course of its executive compensation review project, this remains an area where further analysis is required and disclosure about that analysis is necessary in the CD&A. Compensation consultants are now expressing concerns that companies need to reassess their ownership guidelines because they are now too low, often dating back to a time when the value of equity grants was not as high and most equity awards were in the form of stock options. In addition, there is a growing awareness of the need for adding retention requirements such as hold-until-retirement provisions to top executives' equity awards to ensure that their interests are aligned with stockholders in good times and bad. [To illustrate, executives who ran the sub-prime lending companies that are now struggling or out of business would not have walked away with the same wealth accumulation if they had been required to retain a significant portion of their equity compensation.]

Best Practice Disclosure:

Stock Ownership and Retention Requirements of our CEO and Named Executive Officers

The purpose of stock ownership requirements is to more closely align our key executives' interests with our shareholders—through good times and bad times. We have reassessed our company's stock ownership guidelines of six times salary for our CEO and one times to three times salary for the senior executives and concluded that they are too low. These guidelines date back to a time when equity grant values were not as high, and when most equity was in stock options that resulted in erratic ownership accumulation. Many companies, like ours, are now granting enough full-value shares—restricted and performance shares—to meet their

continued …

guidelines in just a couple of years, with no ongoing stock retention requirements beyond the guidelines once they are met. In addition, the Committee recognizes the importance of attaching retention requirements to our top tier of executives' equity grants to ensure alignment with our shareholders' interests in good times and in bad. As a result we are revamping our ownership requirements as follows:

Increased Ownership Requirements. First, we are increasing the stock ownership guideline ratios to 12 times salary for our CEO and six times salary for our other named executive officers. The Compensation Committee determined these new policy levels by examining our historical grant practices, which indicated that the annual equity grant value for our CEO averaged in the range of eight to ten times salary. Assuming a tax rate of 50% and that the after-tax grant value were held for at least three years, the multiples would be 12 times to 15 times salary for our CEO, and five times to eight times salary for the other named executive officers. Based on this analysis, the Compensation Committee determined that doubling the stock ownership guidelines for our CEO and the other named executive officers is necessary.

Hold-Until-Retirement Policy. Perhaps more importantly, we are now requiring that our CEO and our top tier executives hold 75% of the after tax portion of all stock option and restricted stock grants until retirement or age 60, whichever is later. In addition, we are proud to disclose that our CEO and all of our top tier executives have agreed to apply the same restrictions to all their previously granted outstanding options and restricted stock.

What to Do Now

The types of best practice disclosures that we have outlined above assume that a compensation committee is undertaking the kind of meaningful analysis set forth and the tools referred to. More information about the analytic tools highlighted in these hypothetical disclosures can be found on CompensationStandards.com.

Even if the best practice analytic tools have not yet been implemented, an issuer still needs to provide the level of analysis that the SEC expects—and to say what aspects of compensation or analytic changes that the compensation committee is in the process of reviewing or considering. If there is no underlying analysis on the part of the compensation committee, then the CD&A needs to fully and accurately reflect the company's and the committee's decision-making processes in this regard. Keep in mind that it is never too late to implement the best practices so that the following year's disclosure can be substantially improved—and to protect the board and others from potential exposure. Lastly, we cannot lose sight that along with all this comes the fiduciary obligation of boards and CEOs—and the fundamental responsibility of each of us involved in the process—to face up to and fix any unintended outcomes or amounts or inappropriate practices that may arise from the analysis.

We Welcome Your Input

We would like to thank the various people that gave us comments and feedback as we prepared these disclosures. We encourage our readers to share with us additional examples of best practice disclosures (or suggestions).

—DL

Publisher: **Jesse M. Brill**, J.D. Yale Law School, is recognized as one of the country's leading authorities on insiders' transactions and executive compensation practices and disclosure. Mr. Brill is also the Publisher of the nationally acclaimed newsletters *The Corporate Counsel* and *Section 16 Updates*.

Editors: **David Lynn,** former Chief Counsel, SEC Division of Corporation Finance (dave.lynn@thecorporatecounsel.net).
Michael Gettelman, LL.B. Harvard University, Farella Braun + Martel LLP, San Francisco (mgettelman@fbm.com).
Barbara Baksa, CEP, Executive Director, National Association of Stock Plan Professionals (bbaksa@naspp.com).

The Corporate Executive is published five times a year by Executive Press, Inc. This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent, professional person should be sought.
This publication may not be reproduced in whole or in part without the express consent of the publisher.

Executive Press, Inc. • P.O. Box 21639 • Concord, CA 94521-0639
Tel. (925) 685-5111 • Fax (925) 930-9284 • info@TheCorporateCounsel.net

For Trial Subscriptions, Go to TheCorporateCounsel.net

TheCorporateCounsel.net and CompensationStandards.com present a pair of critical one-day conferences

Essential Practice Tips You Oughta Know

Here is a compilation of practice pointers from the panels of the conference - " Tackling Your 2009 Compensation Disclosures: The 3rd Annual Proxy Disclosure Conference" – co-sponsored by TheCorporateCounsel.net and CompensationStandards.com. The pointers are separated by each panel's topic.

- Your CD&A: The Analysis
- Your CD&A: Performance Targets
- Your CD&A: Hot Spots and Vulnerabilities
- Tackling the Summary Compensation Table Redux
- Analyzing the Equity-Based Tables
- Overcoming Challenges in the Retirement Pay Tables
- Dealing with the Complexities of Perks
- Change-of-Control and Severance Arrangements
- Director Compensation Disclosures
- How to Handle Related Party Transaction Disclosures and Director Independence
- The Latest Form 8-K Developments

"Your CD&A: The Analysis"

By Dave Lynn, TheCorporateCounsel.net

1. **Analysis is the Focus of CD&A** – As John White, Director of the Division of Corporation Finance, noted at our "2nd Annual Executive Compensation Disclosure Conference," the Staff's principal reaction to the Compensation Discussion and Analysis disclosure was "Where is the analysis?" Indeed, the bulk of the Staff's comments on the proxy statements of the 350 companies that it reviewed in Fall 2007 focused on eliciting more analysis in the CD&A. The Staff's October 2007 Report indicated that many comments "asked companies to enhance their analyses of compensation policies and discussions, including how they determined the amounts of specific compensation elements." In seeking this information, the Staff's goal was to elicit discussions "of *how* they arrived at the particular levels and forms of compensation that they chose to award to their named executive officers and *why* they pay that compensation, giving investors an *analysis* of the results of their compensation decisions."

2. **An "Analysis" Caption –** In order to ensure that the analysis is fully captured. we suggest a separately captioned "Analysis" section of the CD&A. This separately captioned section focuses drafters on the requirement to specifically discuss the key analytic tools, the findings from the analysis and how they were used in assessing and setting compensation. This section also serves to highlight the lynchpin for the overall compensation picture – the "why" that puts the rest of the disclosure into context. For an example of a CD&A that provides a separate Analysis section for the discussion of each compensation element, see Eastman Kodak's 2008 proxy statement.

3. **Focus on the Analytic Tools** – There are numerous analytic tools that compensation committees use – and could be using – to determine how much to pay a company's executives and how to pay it. So far, too many companies have focused almost exclusively on the "why" of analysis and haven't paid sufficient attention to "how." Unfortunately, Item 402(b) specifically identifies only one, and perhaps the least effective analytic tool – benchmarking – which may have the unfortunate effect of putting too much emphasis on this already over-used approach. In drafting the CD&A, companies should identify the other analytic tools used by the compensation committee, including specific references to whether the committee used tally sheets, a wealth accumulation analysis and/or an internal pay equity analysis – including how and why the particular analysis was used and the relationship to the articulated compensation policies and decisions. When these key analytic tools are used – as often alluded to in the Staff's comments during its Fall 2007 executive compensation disclosure review project – they should be specifically addressed as topics for discussion in the CD&A.

4. **"To Be Competitive" Is Not Analysis** – The SEC, investors and others scrutinizing CD&As are looking for critical analysis of the elements of compensation, particularly in the context of the total current – and accumulated – compensation. For example, they are looking for justification for severance and retirement and change in control provisions, where a CEO may have already accumulated several lifetimes of "security" so that there is no longer a "need" for safety net provisions. In describing the reasons for compensation decisions, including benchmarking, companies too often fall into the trap of saying the compensation is being awarded "to be competitive," or that any changes to compensation levels will "adversely affect the competitiveness of our compensation program." This is not analysis – instead companies need identify the analytic tools used by the compensation committee, and discuss how and why the particular analysis was used and how it relates to the company's overall compensation policies and decisions.

5. **A Picture is Worth a Thousand Words** – While the CD&A is principally narrative in form, companies are free to use charts, tables and graphs to enhance their disclosure. In practice, many companies supplement their narrative disclosure with alternative formats, with quite a few including more than seven supplementary tables in their CD&As. In its October 2007 Staff Report, the Staff found: "Approximately two-

thirds of the companies we reviewed included charts, tables and graphs not specifically required by the revised rules. In almost every instance, we found these additional presentations to be helpful." The CD&A gives the company an opportunity to tell its compensation story, and very often this story is most effectively told when accompanied by descriptive charts and graphs that can reinforce the discussion and analysis of compensation policies and decisions.

Your CD&A: Performance Targets

By Dave Lynn, TheCorporateCounsel.net

1. **Reconsider Omitting Performance Target Levels** – One of the disappointments of the past two proxy seasons has been that so many companies apparently omitted performance target measures in reliance either on a determination that the performance target levels were not material, or based on a conclusion under Instruction 4 to Item 402(b) of Regulation S-K that the disclosure of these numbers would cause competitive harm. In the absence of disclosure about these performance target levels – and without adequate disclosure about the "degree of difficulty" in meeting those targets when they were omitted – the SEC Staff, investors and others were left without a clear picture of the link between pay and performance at many companies. As a result, compensation disclosures across companies are often not comparable, and perhaps the most critical information for understanding what motivates the named executive officers remains unclear. Performance target levels for completed periods should be disclosed, and performance target levels for current and future periods should only be withheld when there is truly some potential competitive harm. When performance target levels are disclosed for past, current and future periods, it is often much easier to explain how the company strives to pay for performance.

2. **Provide Meaningful "Degree of Difficulty" Disclosure** – If a performance target level must be omitted from the disclosure under Instruction 4 to Item 402(b), companies must discuss how difficult it will be for the executive or how likely it will be for the company to achieve the undisclosed target levels. General statements referencing "stretch goals" or "difficult but achievable" are not considered responsive to this requirement. Some companies have successfully sought to comply with this requirement by providing either a probability analysis of whether the executive or company will achieve the undisclosed target level or by providing a description of target levels for previous years and the executive's or company's historical experience in achieving or failing to meet these prior targets.

3. **Remember to Explain How a Target Level is Derived from the Financials** – Instruction 5 to Item 402(b) provides that when performance target levels are disclosed, companies do not have to comply with the non-GAAP measure disclosure rules in Exchange Act Regulation G and Item 10(e). However, Instruction 5 provides that the company must disclose how the target level number is derived from the company's audited financial statements.

4. **Be Ready with Your Confidential Treatment Argument** – No formal confidential treatment request is required to be submitted to the Staff when a target level is omitted from the executive compensation disclosure in the proxy statement, although the Staff may subsequently request (as it now routinely does during the comment process) a supplemental analysis demonstrating why the exclusion is available. The Staff has accepted arguments as to potential competitive harm when a company was able to articulate very specific reasons why competitive harm could result – including a complete analysis of how a competitor could use the target level data in order to determine competitively harmful information about the company's business operations. The Staff has typically not accepted competitive harm arguments based on the fact that the company does not provide public guidance regarding the particular metric used in its incentive plan.

5. **Don't Forget About Exhibits**– Although no formal confidential treatment request is required to be submitted to the Staff when a target level is omitted from the executive compensation disclosure in the proxy statement, a confidential treatment request may be required if performance target levels are included in an exhibit to a periodic report or a registration statement. A confidential treatment request for target levels redacted from exhibits must be submitted separately for the Staff's consideration under the procedures outlined in Securities Act Rule 406 and Exchange Act Rule 24b-2.

"Your CD&A: Hot Spots and Vulnerabilities"

By Mark Borges, Compensia

1. **Prepare mock-ups of the disclosure tables to reference when you begin drafting.** In the Adopting Release, the Commission indicates that the CD&A is intended, in part, to explain the compensation information that is presented in the disclosure tables and the other required narrative discussions. Consequently, once the company has identified its compensation policies and decisions, it should use the tables as a reference when drafting the CD&A discussion. This will ensure that all relevant topics are considered and discussed, as necessary, and that the tables and related narratives are woven into or cross-referenced in the discussion as appropriate.

2. **Make sure that the discussion of post-employment compensation arrangements and related decisions is consistent with the required tabular presentations of this information.** The discussion of a company's executive compensation program is supposed to cover post-employment, as well as current, compensation arrangements. In this regard, companies will need to ensure that the discussion of various post-employment arrangements (for example, retirement plans) is consistent with the descriptions of these programs that accompany the Pension Plan Table. In describing the rationale for each post-employment plan and arrangement, it may be appropriate to cross-reference the description of the plan or arrangement that is provided in the narrative supplement to the relevant post-employment

disclosure.

3. **Think holistically about your disclosure concerning stock options and other equity-based awards.** While the new rules focus attention on the timing considerations for the grant of stock options, how the grant dates of other types of equity-based awards are determined is likely to be of interest to shareholders in the current environment. Consequently, it is probably worth addressing award determinations more broadly in the CD&A. The questions in the Adopting Release to be considered when addressing the coordination of stock option grants with the release of material, nonpublic information can also be used for purposes of determining relevant disclosure for other types of awards as well.

4. **The Staff (and Investors) are Looking for Detail.** Draft your CD&A with that Objective in Mind. As reflected in the Staff comment letters, an analysis of your executive compensation program and individual pay decisions is based on explaining how (and why) decisions were reached. This means getting into the material details of the factors that influenced pay decisions, whether (and to what extent) the Compensation Committee exercised discretion, and the relationship (or lack there of) between individual pay elements and total compensation. Additional detail may result in a longer CD&A. While this may appear contrary to the Commission's message for the past nine months, in 2008 it's going to be important to get the content of your CD&A right; you can worry about length and plain English with the next version.

By Ron Mueller, Gibson Dunn & Crutcher

1. **Begin now!** Drafting the CD&A this first year will require a significant amount of time. The CD&A cannot be finalized until all of the tables are complete, but if you wait until then to begin drafting, it will be extremely difficult to satisfy the disclosure goals required by the SEC.

2. **Prepare for an iterative process.** Don't expect the CD&A to spring, Venus-like, fully wrought (and writ). Prepare others for the reality that numerous drafts will be necessary and manage expectations by circulating a T&R schedule that allows time for review, feedback and comments on several rounds of drafts which may be in various stages of development. Obtain buy-in from key constituencies early in the drafting process. For example, early in the process, circulate preliminary descriptions of the compensation program's objectives (perhaps with a list of how each arrangement serves each particular objective) to the Compensation Committee or its chairman, senior executives, the heads of HR and IR, outside counsel and the outside compensation consultant.

3. **Remember the "best practices" drafting lessons from MD&A.** Begin with an overview that provides context for the remainder of the discussion; focus on material information and not on immaterial factors that did not affect compensation policies or payments (even if included in the 15 examples under the rules); focus on "why," not just "what;" and do not merely repeat information that is evident from the tables.

4. **Don't lose sight of the Company's message.** If applicable, explain how the Company's view of an executive's "total" compensation differs from the amount reported in the "Total" column of the Summary Compensation Table. Think about, take into account and address issues that may be of concern to your investors. Look beyond the SEC rules and consider what the CD&A says about the Company and its board and executive management. The detail and care reflected in the CD&A will say more to investors than the sentences themselves about the Company's attitude to a highly sensitive and emotionally charged corporate governance matter.

"Tackling the Summary Compensation Table Redux"

By Alan Kailer, Hunton & Williams

1. The rules regarding reporting of salary or bonus deferred into another type of compensation continue to be confusing. According to the latest Staff guidance, the key is whether the receipt of the equity is within the scope of FAS 123R. Salary or Bonus deferred or forgone at the election of an NEO under which equity-based compensation instead has been received by the NEO is to be reported in the column of the SCT applicable to the other form of compensation rather than the Salary or Bonus column if the arrangement is within the scope of FAS 123R (e.g., the right to stock settlement is embedded in the terms of the award). The non-cash compensation must be disclosed in a footnote to those columns and, where applicable, referring to the Grants of Plan-Based Awards Table where the award elected by the NEO is reported. If the award is not within FAS 123R, the amount of Salary or Bonus forgone at the election of the NEO is reported in the Salary or Bonus column and, if it is less than the value of the equity-based compensation received, the incremental value of an equity award would be reported in the Stock Awards or Option Awards columns of the SCT.

2. According to the latest Staff interpretations, if an NEO forfeits a Stock Award, the amount of compensation cost previously disclosed in the SCT is to be deducted from the amount shown in the Stock Awards column in the period during which the award is forfeited. However, only the previously expensed portions of awards that were previously reported in the SCT may be reversed. An expense amount that relates to periods before effectiveness of the new rules or before the person became an NEO is not to be deducted for purposes of the SCT.

3. The Staff (and many others) are particularly fond of supplemental information being provided through tables. One of the areas that supplemental tables may be particularly helpful is the components of the All Other Compensation column. If information in the columns includes several awards or types of compensation, supplemental tables may also be helpful in explaining the numbers included in those columns.

4. Most of the focus on the tables has been on completing the tables themselves. However, Staff comments have pointed out that the narrative accompanying the tables is also important to understanding the information provided. Give careful consideration to this narrative. One idea for making the disclosure more understandable is to use language from the communications to participants in the plans, which tends to be

less legalistic. Another is to consider how a plan will be described before it is adopted; sometimes a slight change in the structure of a plan will result in a much clearer or more compelling disclosure.

By Mark Borges, Compensia

1. **Be sure that description of option valuation assumptions is sufficiently specific.** Instruction 1 to Item 402(c)(2)(v) and (vi) permits a company to cross-reference the discussion of assumptions in the company's financial statements or financial statement footnotes to satisfy the requirement to disclose the assumptions that were used in calculating the grant date fair value of stock awards and option awards.

   Many of these discussions only contain a description of the general assumptions that were used to calculate the grant date fair value of all equity-based awards made during the year, and don't address the specific assumptions that may have been used for executive officer grants and awards (particularly, the expected option term). In this case, a cross-reference may not be sufficient to satisfy the Instruction. The financial statement discussion may need to be enhanced, or the company may simply need to describe the specific assumptions used for grants and awards to the Named Executive Officers in a footnote to the Stock Awards and Option Awards columns of the Summary Compensation Table.

2. **Consider disclosing (and taking into account when tallying total compensation) dividends paid on unvested stock awards.** Even though Item 402(c)(2)(v) and (vi) no longer require disclosure of dividends if factored into an award's grant date fair value, companies should consider disclosing these amounts anyway in a footnote to the appropriate column. The incremental portion of the grant date fair value representing the right to the future dividend stream may underreport the value of this benefit to a named executive officer. This has become an increasingly sensitive area for shareholders, particularly where the dividend payments can amount to hundreds of thousand of dollars and may, in some instances, exceed the NEO's salary for the covered fiscal year.

   If not included in the disclosure, be sure to include in the tally sheet evaluation of the CEO's total compensation (also it may need to be discussed in the CD&A).

3. **Consider using a separate table to disclose the compensation items that go into the All Other Compensation column.** Even though not required, and even though separate identification and quantification of the compensation items that are reflected in the All Other Compensation column is only required for items that exceed $10,000 in value, companies should consider disclosing the value of each item in a table to accompany the column. Such disclosure will enhance the transparency of the information included in the All Other Compensation column and enable shareholders to better evaluate each compensation item. Of course, where a company opts for this approach, it should also consider a separate table for its perquisites disclosure as well.

4. **Consider supplementing the Stock Awards and Option Awards columns with an explanation of how totals were calculated.** The revised approach for disclosing equity awards has rendered these two columns particularly difficult to decipher. Consider providing a footnote that explains, on an award-by-award basis, how much compensation cost was recognized for financial reporting purposes during the fiscal year and explains any special or unique accounting treatment that may have impacted the amount recognized. This should make the column more readable, and may discourage investors from simply substituting the full grant date fair value from the Grants of Plan-Based Awards Table when recomputing total compensation.

By Dave Lynn, TheCorporateCounsel.net

1. **Take "Best Fit" Approach –** Evaluate any particular plan or element of compensation and figure out where it best fits into the framework of the Summary Compensation Table and the other compensation tables, and if there is any doubt or seemingly anomalous result, explain that situation in the footnote or accompanying narrative.

2. **"All Means All" –** The "All Other Compensation" column is meant to capture any compensation not properly reported in the other columns of the Summary Compensation Table, and is not limited to the items enumerated in the rule. As a result, you need to ensure that your disclosure controls and procedures pick up potential sources of non-traditional compensation.

3. **Coordinate with Accountants –** The terms of equity awards significantly impact the reporting of those rewards in the Summary Compensation Table based on the various accounting results under FAS 123R. As a result, decisions about reporting any equity award in the Summary Compensation Table should be done in close consultation with accountants. The accounting result under FAS 123R is not always intuitive, and often depends on the particular circumstances of the award of plan.

4. **Share-Based Accounting 101 –** Given the significant complexities that the SEC introduced when it adopted the expensing approach for presenting equity awards in the Summary Compensation Table, it is helpful to provide investors with a plain English explanation of how FAS 123R works, particularly for the more complex accounting concepts involved with accounting for performance-based, market-based and liability awards.

5. **Beware of Liability Awards –** Avoiding awards that result in liability accounting may aid in reducing year-to-year volatility in the reported equity award amounts. Companies need to be mindful of situations when an award that is subject to equity accounting is modified and becomes subject to liability accounting.

6. **Bonus vs. Non-Equity Incentive Plan Compensation –** The treatment of bonuses and non-equity incentive plan compensation may lead to very little compensation reported in the "Bonus" column, which could give investors the mistaken impression that NEOs are not getting bonuses anymore. In order to avoid this misconception, consider an explanatory footnote to the Summary Compensation Table and some

discussion in the CD&A that explains the distinction and directs investors to where the "bonus" amounts are reported.

By Ron Mueller, Gibson Dunn & Crutcher

1. **Determining how and where some compensation arrangements are reported is not intuitive.** Some annual bonuses are not reported in the "Bonus" column, some performance arrangements that are denominated in cash may be reported as "Stock Awards" and amounts may be reported as earned even if not paid in the fiscal year. You may be surprised to learn that certain compensation arrangements "fall within the scope of SFAS No. 123(R)" and thus are reported as equity awards.

2. **Explain it in the text and footnotes.** A Company will want to explain in Plain English what is being reported, whether the amounts reported were actually received by an executive (and if not, what conditions may apply to the receipt of that compensation) and how the amounts reported in the Summary Compensation Table tie into (and are repeated in and elaborated upon by) information reported in the other tables.

3. **Coordinate the disclosures with your financial statement reporting.** Some of the calculations and disclosures required for the Summary Compensation Table are based on calculations and disclosures made for financial statement reporting purposes. Be sure you understand what those are before the financial statements are prepared (which may be well before the proxy statement is prepared).

4. **Make sure the CEO and CFO understand and are comfortable with the manner in which the numbers in the Summary Compensation Table (and the other Item 402 disclosures) are calculated well in advance of the proxy filing date.** Certifying officers do not like surprises.

"Overcoming Challenges in the Retirement Pay Tables"

By Dave Lynn, TheCorporateCounsel.net

1. **Dealing with Valuations** – An important part of dealing with the pension disclosure is managing perceptions. In order to avoid confusion in the minds of the NEOs, a company should educate their NEOs that the amounts disclosable in the proxy statement will be different than the amounts that the NEO is accustomed to seeing in his or her personal benefits report from the human resources department (which usually describes the annual payment amounts to be receive at retirement age – not a present value amount).

2. **Potential for Large Numbers** – Because the actuarial present value of retirement benefits represents a present value of all actuarially determined future payments under a retirement plan, the number is likely to be much larger than the annual benefits that were previously required to be disclosed in a generalized table. As a result, the disclosure must clearly present the information as an estimated value, subject to all of the assumptions that are specified.

3. **Changes from Year-to-Year Likely** – The value of pension benefits will vary from year to year for NEOs, but not exclusively due to the accrual of additional benefits as they age. Because the reported number is a present value, it is sensitive to any changes in the assumed discount rate or lump sum rate (if applicable). As a result, the disclosure should clearly highlight any year-to-year changes in assumptions and the extent to which those changes affect the reported value of the pension plans.

By Mark Borges, Compensia

1. **When faced with a choice between alternative approaches for disclosing estimated benefits under a defined benefit pension plan, consider showing the larger amount if its receipt is not subject to a material contingency.** Given the variations in features of defined benefit pension plans, it is possible that a plan may present payment alternatives or situations that are not explicitly addressed by the new rules. In an instance where this occurs and technical compliance with the rules would lead to the disclosure of the smaller payment amount, consider disclosing the larger amount with appropriate footnote disclosure highlighting the alternatives and explaining the reasons for the potential differences in the payment amounts. This will avoid confusion and any potential issues about misleading disclosure.

2. **Establish procedures for tracking compensation amounts reported in the Summary Compensation Table that are deferred into nonqualified defined contribution plans and nonqualified deferred compensation arrangements.** To minimize doubled-counting, the instructions to the Nonqualified Deferred Compensation Table require a company to identify amounts reported in the Table that have previously been reported as compensation in the Summary Compensation Table. Most companies do not have existing systems that easily lend themselves to tracking this information. Consider setting up an internal system that will record on an annual basis each item (and amount) of annual and long-term compensation that is subsequently deferred by a named executive officer so that this information can be presented as required to supplement the information in the table.

By Michael Kesner, Deloitte Consulting

1. Prepare "dry run" before yearend and review the results with the Compensation Committee. Determine if corrective action should be taken to eliminate or modify arrangements that are inconsistent with the compensation philosophy or pay environment.

2. Coordinate the disclosures required by this section with the CD&A. If appropriate, have the Compensation Committee revisit certain aspects of the retirement and deferred compensation arrangements:

- Purpose of each plan or program
- Definition of covered compensation
- Rationale for SERP
- Investment alternatives

3. Develop list of key assumptions and data requirements that need to be made to complete the required calculations as of yearend, and coordinate approval of such assumptions by corporate accounting and outside actuaries to ensure consistency with the financial statement reporting.

4. Consider terminating the nonqualified deferred compensation plan(s) and paying out the existing balances under the Section 409A transition rules to eliminate the cost of such programs and the disclosure of the program.

By Ira Kay, Watson Wyatt Worldwide

Some consultants have been recommending that the full "walk away" value to be received by named executive officers at termination or change in control be presented to the compensation committee for their consideration as they make compensation decisions for the current year. Many compensation committees already have reviewed this information at the time of approving a new NEO pay package in response to the Disney cases. This should be done annually. This approach would include two enhancements over what is currently being required by the SEC in the proxy disclosures of "Other Potential Post-Employment Payments."

1. Show the in-the-money value of previously vested options as a separate line from the in-the-money value of options that would vest at the designated event. Thus, as in the example presented, if the executive resigns and gets no more option vesting at that event, it would be very easy to see the value of what already is vested in a line separate from the zero value represented in the accelerated equity grants line.

   Consultants also are recommending that companies consider including the total "walk-away" value in the Other Potential Post-Employment Payments section of the proxy. The view is why make shareholders hunt for that information elsewhere in the proxy (where it is available from the Outstanding Equity table if they then subtract the exercise price from the year-end stock price) if instead the values can easily be calculated for readers.

2. Show the pension value previously shown on the Pension Table so it may easily be compared to the enhanced value being provided at various termination or change in control events. As in the example presented, many companies already depict the accrued pension value in the Voluntary Resignation column so that understanding the value of incremental enhancements is relatively straightforward. Those lines are totaled at the bottom to show a full "walk-away" value.

By Pamela Baker, Sonnenschein Nath & Rosenthal

1. Get started early on the new pension disclosures. The tables are radically different from prior disclosures and preparation of the new disclosures will require the coordination of HR, the actuaries and the accountants, at a minimum. In addition for some companies, different departments are responsible for the records on qualified plans and nonqualified plans, thereby requiring even more coordination. The SEC instructions permit incorporation of various assumptions by cross-reference to the discussion of assumptions in the company's financial statements or the MD&A but the financial statements are not uniform in which assumptions they state, so don't count on being able to incorporate by reference.

2. The Company should consider streamlining the number and variety of actuarial or defined benefit plans it offers to NEOs in order to simplify disclosure and avoid some of the costs of recalculating benefits from year to year and explaining shifts in benefit amounts that may occur among plans for technical reasons when the overall benefit is unchanged. For example, a company with a traditional pension plan and an excess benefit plan and a SERP, where the benefit under the excess plan is offset by the benefit under the qualified plan and the benefit under the SERP is offset by both the benefit under the qualified plan and the benefit under the excess plan may want to eliminate the NEOs from the excess plan and simply cover them under the SERP, with the SERP benefit offset by the qualified plan benefit.

3. The footnote disclosure under the non-qualified deferred compensation table (identifying what portion of the amounts shown have previously been reported as compensation in the SCT) may not paint the picture the company wants to paint. For various reasons (e.g., mergers, promotions to NEO status) amounts electively deferred may not have been previously reported in the SCT (or elsewhere). Companies should consider whether supplemental disclosure would be appropriate, showing what portion of the total aggregate account balance represents amounts the executive could have taken in cash but electively deferred.

4. The new tabular and footnote disclosures (e.g., actuarial assumptions) are subject to the disclosure controls and procedures leading to the required CEO and CFO certifications. New controls will need to be designed or existing controls will need to be modified to capture this new data. Advance planning is needed to avoid this becoming a last-minute problem.

"Analyzing the Equity-Based Tables"

By Martha Steinman, Dewey & LeBoeuf

1. One of the greatest challenges in reporting equity awards is how to classify the award, i.e., stock based or non-stock based. The answer is largely accounting driven and often far from intuitive. Accordingly, you need to coordinate closely with your accountants to determine the proper classification of an award <u>before</u> you venture too far down the road as to the rest of the related disclosure.

2. Why say it three times when you can say it one time? In the collective zeal to provide full disclosure in the first filing season under the new rules, many descriptions of the details of awards appeared multiple times in the disclosures. For the second season, try to focus on

describing the details of awards once – following (or as footnotes to, if applicable) the relevant table.

3. Do not underestimate the time it will take you to prepare these disclosures, including all the footnotes. Just because it has now been done once will not make it "easy" to collect the data the second time around, particularly given the uncertainty during the first season as to how to characterize certain arrangements and a potential desire to now revisit some of those past decisions. It is not too early to start collecting and compiling the relevant data.

4. Many of the SEC comment letters asked for footnote disclosure regarding the assumptions used in valuing equity awards. Review your disclosures and be sure you are referencing where the assumptions are discussed, whether in your financial statements (or footnotes) or in your MD&A.

By Alan Kailer, Hunton & Williams

1. If on exercise of an option the NEO receives shares that are subject to the registrant's right to repurchase if the NEO terminates employment before a specified date, and the NEO exercises the option before the restrictions lapse, the exercise is not reported in the Option Exercises and Stock Vested table, but the shares should be shown as stock awards in the Outstanding Equity Awards table and the vesting of the stock awards reflected in this table as it occurs.

2. Where the number of shares or options that will vest is tied to the achievement of performance criteria, the staff has informally indicated that the amount to be reported in the Grant Date Fair Value column should be the grant date fair value of the maximum number of shares or options that could be earned.

3. It can be difficult to decide in which column of a table to report certain kinds of compensation. The Grants of Plan-Based Awards table seems to have presented the most difficulties; the Staff has issued a number of comments questioning the placement of particular awards in this table. Before beginning to complete the table, carefully review each award to determine whether it is an incentive or solely a time-based award.

By Howard Dicker, Weil Gotshal & Manges

1. **There Are Additional CD&A Disclosure "Requirements" Regarding Equity Grant Practices in the Body of the SEC's Adopting Release In the CD&A, a company is required to address matters relating the timing and pricing of equity grants to its NEOs.**

   The SEC's adopting release (Release No. 33-8732A (Aug. 29, 2006; http://www.sec.gov/rules/final/2006/33-8732a.pdf) rather than the text of the rule (Item 402(b) [CD&A]) elucidates this requirement.

   With respect to timing, the release states that if a company had since the beginning of the last fiscal year, or intends to have during the current fiscal year, a program, plan or practice to select option grant dates for executive officers "in coordination" with the release of material non-public information, the company should disclose that in the CD&A. If this is the case, the company should disclose in CD&A that the compensation committee may grant options at times when it possesses material non-public information, and the company would need to consider disclosure about how the compensation committee takes such information into account when determining whether and in what amount to make those grants. This has come up in some of the recent comment letters issued by the SEC staff. The release, beginning on page 25, sets forth a non exhaustive list of questions that a company should consider addressing in its CD&A.

   With respect to setting the exercise price, the release states that a program, plan or practice of setting the exercise price at other than the closing price on the actual date of grant will require disclosure in the CD&A (as well as in an added column to the Grants of Plan-Based Awards table). Thus, even a company making grants to NEOs with an exercise price based on the average of the high and low sale prices on the date of grant or based on the closing market price preceding the date of grant must discuss this in the CD&A (and will also need to add a column to the table).

   Even though the SEC release focuses on option grant practices, in interpretive material the SEC staff has clarified that these disclosure requirements extend to equity-related awards generally (e.g., restricted stock and stock units and SARs).

   Obviously, in the current environment, these matters require careful attention and, in some cases, investigation. For example, what was the "practice" during the last fiscal year?

   I have included a separate handout that illustrates a few grant practice disclosures.

2. **Additional Columns May Be Required for the Grants of Plan-Based Awards Table**

   What's the "grant date"? If the option "grant date" is different from the date the compensation committee takes action or is deemed to take action to grant an option, a separate column is required to be added to the Grants of Plan-Based Awards table showing such date. Remember that "grant date" and "date or grant" are now terms defined in Item 402 and refer to the grant date determined for financial statement purposes under FAS 123R. This means you will need the assistance of an accountant because even aside from any improper conduct, the date is not always what you might have expected.

   For example, if the compensation committee met on July 10 and made option awards but specified that the exercise price shall be the closing price of the stock on July 28 (which is intended to be two days after the earnings press release), then ordinarily the "grant date" under FAS 123R would be July 28. Also, for example, if on November 20 the board approves a new equity incentive plan subject to stockholder approval at the next annual meeting, and on December 5 the compensation makes option awards under the plan prior to such approval, and on May 22 shareholders approve the plan, then usually the "grant date" will be May 22, the date of stockholder approval. Take a look at paragraph numbers A77-78 of FAS 123R.

   What happens if the exercise price of an option award is less than the "closing market price" of the stock on the date of grant? Add a column

to the table and disclose the closing market price. Don't believe this applies? Be sure to double check. As stated above, consider a plan or grant that specifies that the exercise price be set at the average of the high and low sale prices on the date of grant. Or one specifying that the exercise price be the closing market price on the date *immediately preceding* the date of grant. Also consider situations where the "grant date" is not necessarily what you may have expected (e.g., the stockholder approval illustration above).

3. **Be Prepared for Disclosing an Inventory of Outstanding Options**

The Outstanding Equity Awards at Fiscal Year End table requires disclosure of outstanding options held each NEO on an award by award basis. This means that for each NEO there will be a separate row in the table for each outstanding option, disclosing, among other things, the number of shares underling the option, the exercise price and the expiration date. However, multiple awards may be aggregated where the exercise price and expiration date are identical. The vesting schedules also must be disclosed in footnotes. Consider a company that has granted options to its NEOs on a quarterly basis during the past ten years. It's possible there will be nearly 40 rows per NEO! That surely will requires some extra space in the proxy statement. I haven't seen that many rows, but I have seen 25 rows or so frequent enough. Whether because of this table or all the other disclosures under the new rules, companies have needed to plan for proxy statements with more pages and adjust their packaging and mailing requirements. Maybe the new “shareholder choice” (a/k/a “e-proxy”) SEC rule amendments will provide some benefit here.

4. **Disclose the number of shares pledged as security by management.**

Brokerage accounts often implicate a pledge.

Item 403(b) of Reg S-K now requires the table of management's beneficial ownership to include disclosure, by footnote or otherwise, of the number of shares that are pledged as security. Companies should be sure they have updated their D&O questionnaires to capture this information (with illustrative examples of arrangements that may involve a pledge).

Some pledges should be relatively easy to identify. For example, an executive officer has an outstanding loan to a bank, has pledged a particular number of shares, and has delivered a stock certificate for such shares to the bank. Similarly, most hedging arrangements with brokerage firms, such as prepaid variable forward contracts and equity collars, involve a pledge of the underlying shares of the registrant's stock subject to the hedge.

Normally, all securities (including shares of the registrant) held in a margin account at a brokerage firm are pledged to the firm as security for amounts owing to the firm. Thus, all of the shares of the registrant held in the account could be considered pledged and disclosable. Companies should consider beneficial ownership footnote disclosure along the following lines: "Ms. X maintains margin securities accounts at brokerage firms, and the positions held in such margin accounts, which may from time to time include shares of Common Stock, are pledged as collateral security for the repayment of debit balances, if any, in the accounts. At [March 31, 2008], Ms. X held [1,500] shares of Common Stock in such accounts." Here is another approach taken by a company “Includes shares pledged as security, including shares held by brokers in margin loan accounts whether or not there are loans outstanding, as follows: Mr. A, 10,000 shares; Ms. B, 5,651,186 shares; Mr. C, 582,000 shares; and all directors and executive officers as a group, 6,586,708 shares.” Some brokerage customer agreements may also treat securities held in non-margin (or "cash") accounts as pledged collateral as well.

While Item 403(b) does not specifically require disclosure of the nature of the pledge, companies should consider describing the circumstances. One can expect that disclosure of pledges pursuant to customary brokerage arrangements will become boilerplate over time.

Companies should note that pledge disclosure is required for directors and executive officers as a group, as well as for the directors, nominees and NEOs by person. So pledge information for all executive officers, not just NEOs, must be obtained by the company.

Companies should review their insider trading policy and consider reminding directors and executive officers of its application to pledges and the other implications of pledges (e.g., Section 16 sale on foreclosure).

If no pledge disclosure is desirable, companies should encourage directors and executive officers to make other arrangements. This could include for specific security interests, substituting other collateral if permitted, or for brokerage accounts, having the brokerage firm explicitly exclude company securities from any pledge or security provisions of the customer agreement.

5. **Include "directors' qualifying shares" in management's beneficial ownership table.**

Item 403(b) of Reg S-K requires the table of management's beneficial ownership to include so-called "directors' qualifying shares." These are securities that an individual has acquired to satisfy a requirement that such person be a security holder of a company in order to serve on the company's board of directors. The requirement is usually imposed by law and included in the company's charter or by-laws. It is commonly found in the banking industry and in companies formed outside the U.S. It is not the same as a company's ownership guidelines, if the company has one. Registrants should consider highlighting, by footnote or otherwise, the number of directors' qualifying shares included in the total number of shares beneficially owned.

It also is important to ascertain whether any member of the registrant's management has director qualifying shares in any parent or subsidiary of the registrant since Item 403(b) additionally requires beneficial ownership disclosure of equity securities of any of the registrant's parents or subsidiaries.

Companies should be sure that they have updated their D&O questionnaires.

By Dave Lynn, TheCorporateCounsel.net

1. **Take "Best Fit" Approach –** Evaluate any particular plan or element of compensation and figure out where it best fits into the framework of the equity compensation tables, and if there is any doubt or seemingly anomalous result, explain that situation in the footnote or the accompanying narrative. Additional columns may also be added to the tables to help classify or identify awards or to provide additional information, so long as the additional information is not misleading or does not otherwise render the required information misleading.

2. **The "Life Cycle" Perspective –** The SEC designed the equity tables—the Grants of Plan-Based Awards Table, the Outstanding Equity Awards At Fiscal Year-End Table and the Option Exercises and Stock Vested Table—to portray the "life cycle" of an equity award, from its initial grant, through the time that it is outstanding to its ultimate exercise or vesting. Keeping this perspective in mind, equity awards are presented in the Grants of Plan-Based Awards Table only in the year when granted. In the year granted and in subsequent years, the award is reported in the Outstanding Equity Awards at Fiscal Year-End Table (with classification in the table depending on whether or not it remains an equity incentive award or becomes an award subject only to time-based vesting), until the option is exercised, the stock vests or the award is transferred for value, in which case the award is reported in the Option Exercises and Stock Vested Table in the year when the exercise, vesting or transfer occurs.

3. **Make Equity Tables More User-Friendly –** While companies can't change the prescribed format of the equity tables, it is possible to make some changes that may make the tables more understandable and easier to use. For example:

    - A company may want to add a "Grant Type" column to the Grants of Plan-Based Awards Table in order to differentiate the types of awards presented so the information presented in the table is better tied to the discussion and analysis in the CD&A.
    - In the Outstanding Equity Awards At Fiscal Year-End Table, a company may follow Question 122.02 of the SEC Staff's Regulation S-K Compliance and Disclosure Interpretations, and satisfy the vesting disclosure requirement by including a column in the table showing the grant date of each award and including a statement of the standard vesting schedule applicable to each reported award.
    - For the Option Exercises and Stock Vested Table, a company may want to clarify by footnote or accompanying narrative disclosure that the amounts presented for "value realized" upon exercise or vesting may not mean that the NEO has actually sold the securities for cash and thus is no longer "at risk."

4. **Avoid "Springing" Columns –** When reviewing option granting practices, companies should consider the "springing" columns of the Grants of Plan-Based Awards Table that must be added in particular circumstances relating to the grant date and the exercise price relative to the closing market price on the grant date. While these springing columns may be triggered for perfectly legitimate reasons (e.g., the company uses an average of the high and low prices on the grant date rather than the closing market price), it may be advisable to revisit these policies so that going forward these columns won't be triggered and raise any questions about the company's option grant practices.

5. **Consult with Accountants –** When determining the grant date to report in the Grants of Plan-Based Awards Table, it is important to consult with accountants to ensure that the grant date used for executive compensation disclosure purposes is consistent with the grant date used for accounting purposes. Similarly, whether something is reported as an equity award in the tables is determined by reference to FAS 123R, so accountants should be involved in making any such determination.

"Dealing with the Complexities of Perks"

By Alan Dye, Hogan & Hartson and Mark Borges, Compensia

1. **Identify all benefits that might be considered perks.** The Commission has taken a broad view of what constitutes a perquisite. Companies should apply the Commission's guidance to determine what benefits, if any, are provided to directors or executive officers that might be considered perks.

    The value of any perks identified, if they exceed $10,000 in the aggregate, will need to be taken into account in determining which executive officers will be NEOs, and will be disclosable in the Summary Compensation Table (or the Director Compensation Table).

2. **Establish disclosure controls and procedures to track perk usage.** The value of a perk is based on the aggregate incremental cost to the company of providing the perk. For non-cash perks that involve personal use of company assets (e.g., aircraft, automobiles, or tickets to entertainment events), calculating the cost of personal use will require tracking the extent of personal use and the cost associated with that use. Companies should develop procedures for tracking personal use, and incorporate those procedures into the company's disclosure controls and procedures.

3. **Revise the D&O questionnaire to elicit information about perks.** The annual D&O questionnaire should be updated to elicit information about possible perks. The questionnaire should provide examples of what might constitute a perk, to trigger recollection of infrequently provided benefits that might constitute perks and that sometimes are difficult to track through internal controls (spouse's travel to company-sponsored event, director's use of stadium skybox).

4. **Develop a methodology for calculating the aggregate incremental cost of perks.** Determining the aggregate incremental cost to the company of non-cash perks may require difficult calculations and/or judgments about the allocation of costs between the company and the recipient of the benefit. Determining the cost of personal use of corporate aircraft or company-owned cars, for example, may involve

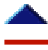
calculation of the cost of a particular trip as well as allocation of the fixed costs of ownership of the aircraft or car.

Companies will need to develop a methodology in order to value perks for purposes of the compensation tables. The methodology should be reasonable, since it will have to be explained in the proxy statement (in plain English) if the perk to which it relates has to be separately quantified in a footnote.

5. **Don't forget the foregone income tax deduction when computing the aggregate incremental cost of the personal use of corporate aircraft.** Internal Code Section 274(e) limits the deductibility of expenses associated with the personal use of corporate aircraft to the amount recognized as income by the corporate executive using the aircraft. Since the aggregate incremental cost of an executive perquisite may need to encompass the indirect, as well as the direct, costs to the company of the perquisite or personal benefit, any foregone tax deduction may need to be factored into the cost calculation.

6. **Remember that the identification and quantification requirements for perquisites only apply to the most recent fiscal year covered in the Summary Compensation Table.** While this won't be an issue with respect to the first year under the new disclosure rules, be aware that companies only have to describe each perquisite or quantify perquisites that exceed the greater of $25,000 or 10% of an individual named executive officer's total perquisites for the most recent fiscal year covered in the Summary Compensation Table. This will help save space when preparing the SCT in 2008 and thereafter and providing the necessary supplemental disclosure to the All Other Compensation column.

7. **Club memberships that are not used exclusively for business purposes will be a disclosable as a perquisite even though the company may not incur an incremental cost for such use.** The Adopting Release indicates that club memberships that are not used exclusively for business purposes will be a disclosable perquisite. In most cases, companies may opt to pro rate the cost of the membership between business and personal use for disclosure purposes. Even where there is no incremental cost to the company of such personal use, the membership will be disclosable as a perquisite if the $10,000 minimum disclosure threshold is reached. Instruction 4 to Item 402(c)(2)(ix) states that once the $10,000 disclosure threshold is reached or exceeded each perquisite, regardless of amount, must be identified by type in a footnote to the All Other Compensation column.



"Change-of-Control and Severance Arrangements"

By Scott Spector, Fenwick & West and Mike Kesner, Deloitte Consulting

1. **We suggest that a table be used to supplement the narrative explanation of benefits and assumptions.** The inclusion of a table makes it easier for the reader to understand exactly what benefits an executive is entitled to receive upon a termination or a change of control. The inclusion of a table will also aid the reader in making comparisons between executives, factual situations, and across companies.
2. **Appropriate cross references should be made to the Company's CD&A discussion of employment, severance and change of control agreements, as well as other narrative or footnote discussions throughout the tables.** Having cross references will help ensure that the description of arrangements is consistent, complete and accurate throughout the filing. In addition, including footnotes to the tables will allow the information contained in the tables to be easily understood at a glance while still providing detailed and complete information.
3. **Care should be taken to disclose all of the definitions and all material operative assumptions and conditions that relate to triggering events for severance and change of actual payments.** The definition of terms such as "Cause", "Good Reason" and "Change of Control" can have a impact on the amount of benefits to which an executive will be entitled in the event a change in control or termination occurs.
4. **Consider stating that the reasonable estimate (or range) of costs of Section 280G gross-up payments does not take account of mitigation for payments being paid in consideration of non-competition agreements or as reasonable compensation.** The amount of a potential 280G gross-up payment can be significantly reduced by assuming that a portion of the compensation is either reasonable compensation or attributable to a non-competition agreement. By stating that the 280G gross-up amount estimate is not reduced by these factors provides investors with the maximum cost exposure the company would be subject to in the event of a change in control. It also avoids providing details to the IRS of the company's ultimate tax position but preserves the company's ability to take such positions. In addition, the assumptions used in calculating the 280G gross-up amount should be described (for example, tax rates, option assumptions, and discount rates).
5. **We recommend that the Committee review a "dry-run" of this table before year end, and consider modifying these arrangements, as appropriate.** This will enable the company's compensation committee to consider whether changes to agreements are necessary or appropriate before the effective date of the new rules.

"Director Compensation Disclosures"

By Keith Higgins, Ropes & Gray LLP and Scott Spector, Fenwick & West

At last year's conference, the segment on “Crafting the New Director Compensation Disclosure” offered six items for companies to consider in

preparing the disclosure about director compensation. We thought this year we would review those suggestions and see how widely they were followed.

1. **Consider CD&A Discussion of the Principles of Director Compensation.**

   Some companies took us up on the suggestion, but in an unscientific survey it appears as if the vast majority of companies did not. The approaches varied. One company described what the director compensation program was designed to do in four discrete bullet points. Another company said that its goal was to maintain director compensation "above the mid-point" of comparable companies (which presumably gave it a lot of headroom). But most companies just disclosed what the compensation was, both in narrative and tabular format.

   Why no discussion and analysis? Beside the fact that the rules don't technically require it, we suspect that CD&A fatigue began to set in. What might have sounded like a good idea when the rules were fresh and untested, probably seemed quite a bit less good when the regular CD&A stretched to a dozen or more pages. Perhaps the decision was made – and the director CD&A fell to the cutting room floor – shortly after Chairman Cox made his speech criticizing the lengths to which CD&As were growing. It probably bears mentioning that most director compensation is relatively non-controversial. That always helps. However, it might be useful to discuss why an issuer uses RSUs or restricted stock versus options and how the issuer makes such determinations. It would also be good practice, as well as good disclosure, to indicate whether a compensation survey is used and to mention peer groups as with employees. Of course, disclosure about the use of consultants for director compensation is required.

   It appears that a separate, director-only CD&A is not a developing best practice.

2. **Consider Describing All Perquisites Even If Below New Disclosure Threshold.**

   This suggestion was an interesting one in that the new rules ushered in a safe harbor for director perks that had not been the case under the former rules. Now all of a sudden directors got the same $10,000 perk radar screen to which NEOs were entitled. There was a fear that directors would use this newly found threshold to hide a rich life of under $10,000 director perks.

   It was hard to figure out how many companies took us up on our suggestion. Some expressly cited the $10,000 threshold and indicated they were only disclosing amounts above the threshold. Some companies disclosed each perk and other item in a separate table in a footnote to the table. Much of the disclosure in the "All Other Compensation" column of the Directors Compensation Table relates to the next suggestion.

3. **Weigh the Costs and Benefits to the Company of Director Legacy and Charitable Gift Programs.**

   Maybe companies took the advice, but just concluded that the scales tipped in favor of maintaining the programs. In our decidedly unscientific survey, we note that the single most frequent item appearing in the "All Other Compensation" column related to the cost of director charitable gift programs. The SEC staff didn't help at all here by requiring this disclosure to be made even if the program was provided to directors on exactly the same terms as provided to all rand-and-file employees. But, it's good that the grumpiness about the new rules didn't dampen the spirit of charitable giving. Or is it?

4. **Address Committee Policies and Procedures for Determining Director Compensation.**

   We didn't really go too far out on a limb here – paragraph (e) of Item 407 of Regulation S-K requires this disclosure. And most companies made some effort to describe the process by which director compensation was set. Don't forget to include the role that any consultants played in helping to set compensation design and levels. Again, we did not see too much analysis here either, consistent with our comment above. If a compensation consultant hired by a compensation committee to help with executive compensation advises the committee on director compensation, is that consultant's independence somehow compromised? We didn't see that disclosure in any 2007 proxy statements that we reviewed and we hope that trend continues.

5. **Consider Disclosing the Specific Compensation of Each Director by Name Even if Compensation Is Identical.**

   Grouping directors with all of the same elements of compensation is an idea whose time, we are happy to say, never came. Although there may have been companies that did it, there were none that we saw. The motive was decidedly well-intentioned, but the likelihood that director compensation would be exactly the same seemed remote in many cases, and besides it just isn't that hard to list them all out (makes it easier to count noses to make sure no one is missing).

6. **Note the Differences in the Supplemental Disclosure for Outstanding Director Equity Awards.**

   All outstanding stock awards, whether vested or unvested, have to be listed in a footnote for each director. So same of the same information that goes into that gigantic Outstanding Equity Awards table for NEOs get tucked away in a footnote to the Director Compensation table. That is often a lot of information, but the rules don't require for directors that it be presented on a grant-by-grant basis, or that exercise prices being broken out, or that vesting dates be shown.

   So what is the best practice here? We're not sure. Some of the more extensive information required for NEOs goes to the wealth accumulation aspect of the compensation tables and whether outstanding awards affect (or should affect) decisions about future compensation. Well, that really doesn't apply very much to directors, who get a standard compensation package that it is laid out in narrative form each year and where the numbers are not typically so staggering as to require some wealth accumulation throttle on future compensation.

"How to Handle Related Party Transaction Disclosures and Director Independence"

By Alan Dye, Hogan & Hartson and Keith Higgins, Ropes & Gray

1. **Revise your D&O questionnaire to pick up the transactions disclosable under Item 404(a).** The annual D&O questionnaire should be updated to elicit the information necessary to determine whether any director or executive officer had a disclosable material interest in any transaction or proposed transaction since the beginning of the last fiscal year. The questionnaire should be revised to increase the transaction threshold from $60,000 to $120,000, reflect the new definition of "immediate family member," eliminate questions relating to the safe harbors in old Instruction 8(C) and Item 404(b), and solicit information relating to director independence under Item 407.
2. **Review the status of compensation committee members under Rule 16b-3 and Section 162(m).** The elimination of the safe harbors in Instruction 8(C) and Item 404(b) may have the effect of requiring disclosure of transactions with outside directors that were not previously disclosable under Item 404(a) or (b). Any outside director who has a relationship with the registrant that will now have to be disclosed Item 404(a) may no longer qualify as a "non-employee director" for purposes of Rule 16b-3 or as an "outside director" for purposes of IRC Section 162(m). At the same time, the higher dollar threshold for disclosure of related person transactions may mean that some transactions that previously were disclosable will no longer have to be disclosed. Companies should review the status of all outside directors to determine their eligibility to serve on the compensation committee.
3. **Adopt a written policy for approving related person transactions.** Because new Item 404(b) requires disclosure of whether the company has a policy or procedures for approving related person transactions and whether the policies or procedures are in writing, companies that don't have a written policy should consider adopting one. The policy should take into account applicable stock exchange listing standards.
4. **Make sure that all compensation of non-named executive officers is approved by the compensation committee.** Compensation paid to executive officers who are not NEOs is not disclosable under Item 402, but may be disclosable under Item 404(a) if not approved (or recommended for approval) by the compensation committee or a group of independent directors performing that function. Stock exchange listing requirements generally require compensation committee approval (or recommendation) of compensation paid to all executive officers, but companies should make sure that all elements of compensation paid to non-named executive officers (or at least those elements exceeding $120,000) have been identified and approved by the compensation committee.

"The Latest Form 8-K Developments"

By Dave Lynn, TheCorporateCounsel.net

1. **You May Need to Go Beyond the "Bare Bones" Requirements** – Even with the burden reduced by the 2006 amendments, a substantial number of compensatory events must be disclosed on Form 8-K. A significant concern in providing Form 8-K disclosure of compensatory arrangements is that the information must be provided outside of the context of the proxy statement, where disclosure such as the CD&A can put the information in perspective. As a result, Form 8-K disclosures about compensatory events must be carefully drafted within a very short timeframe – and in many cases, additional disclosure over and above what is specifically required must be included to place the required information in proper context.

2. **Dealing with Officer Appointments** – When a PEO, PFO, president, principal accounting officer, principal operating officer is appointed, a company must file a Form 8-K that discloses the name and position, the appointment date and a brief description of any material plan or arrangement that is part of that appointment (as well as the information required by Items 401(b), (d), (e) and Item 404(a)). The SEC did not extend these 8-K disclosure requirements regarding appointments to the other NEOs who have (or would have) obtained such status by virtue of being among the three most highly paid executive officers. Once disclosure is provided about an appointment, no further Form 8-K disclosure regarding compensatory events is required for that person, unless he is a PEO, PFO or NEO covered by Item 5.02(e). For an officer not covered by Item 5.02(e), if a grant is made or an arrangement is entered into – but that did not happen in connection with the appointment – then no disclosure about that compensatory event is required in the Form 8-K announcing the officer's appointment. Unlike Item 5.02(e), the reference to plans or arrangements in Item 5.02(c) is not limited strictly to "compensatory" plans or arrangements – so material non-compensatory arrangements are subject to disclosure under this paragraph.

3. **Meeting Item 5.02(e)'s Disclosure Requirements** – Item 5.02(e) requires a brief description of the terms and conditions of the plan or arrangement and the amounts payable under it. The SEC has stated that, when consistent with General Instruction B.3. to Form 8-K, it is permissible to satisfy this requirement by cross-referencing a description from the company's most recent Form 10-K or proxy statement (however, this is not permitted for material amendments, grants or awards). A "brief description" contemplates a summary and not a mere recitation of the terms – and incorporation by reference to an exhibit does not satisfy this requirement.

4. **Relief for Discretionary Salary Changes and Bonuses** – Under the old Item 1.01 standard before the 2006 amendments, the determination of whether a discretionary bonus or salary increase for a NEO triggers a Form 8-K filing was very much a facts-and-circumstances analysis. Today, with executive compensation disclosure focused in Item 5.02(e), and with Question 117.13 of the Staff's Regulation S-K Compliance and Disclosure Interpretations, a company can take that position that an annual discretionary bonus or salary increase is not reportable no matter what the amount. Disclosure regarding material information about a discretionary bonus or salary increase would instead be included in the issuer's CD&A and related disclosures under Item 402 of Regulation S-K. The Staff has seemed to accept the extension of the position in Question 117.13 to discretionary salary increases. The only problem then is whether you still have to file a schedule of salary increases as an exhibit to a periodic report on the same theory that would have required them to be reported on Form 8-K under 1.01, and on this point practice is mixed – some companies file schedules listing salary increases and bonuses while others

do not.

5. **Keep In Mind the "Previously Reported" Exception** – General Instruction B.3. to Form 8-K provides that if substantially the same information required under Form 8-K has been previously disclosed, then no additional report on Form 8-K is required. The term "previously reported" is broadly defined in Exchange Act Rule 12b-2 to include any Form 8-Ks, 10-Qs, 10-Ks, proxy statements and registrations statements, etc. Under this General Instruction, if information that would otherwise be filed in a Form 8-K is included in a Form 10-Q or Form 10-K, the Form 8-K is not necessary. This typically happens only if a company coincidentally is about to file a Form 10-Q or Form 10-K due to the relatively short deadline for filing a Form 8-K. Since some investors accuse companies of "burying" information when they take advantage of this General Instruction – many investors have come to rely on Form 8-K filings as the way companies inform the market of a material development – some companies still file a Form 8-K rather than include the information in their periodic reports. However, some companies do file their "triggering event" information in a Form 10-Q or Form 10-K and don't bother with a Form 8-K if the circumstances permit. In addition, if an Item of Form 8-K calls for disclosure of a previously reported event or transaction, then any information required in the new report (or an amendment) that was previously reported may be incorporated by reference.

By Keith Higgins, Ropes & Gray and Alan Dye, Hogan & Hartson

1. **Fine tune whom your Item 1.01 disclosure controls and procedures pick up.** The revisions to Form 8-K no longer require current disclosure when you enter into compensatory arrangements with your directors. You can stand down on your current vigilance. But don't fall asleep altogether and just leave it to the annual D&O questionnaire. Compensatory arrangements with directors, and any amendments to them whether or not material, must be filed with the periodic report for the period during which they were entered into.

2. **Calibrate whom your Item 5.02 disclosure controls and procedures pick up.** The revisions to Form 8-K now require that any retirement, resignation, termination of employment of a "named executive officer" be disclosed currently. Previously, only the "principal officers" or directors were covered. Because an Item 5.02 disclosure is one that carries real consequences if you miss it (i.e., loss of Form S-3 eligibility, no liability safe harbor), make sure these are picked up. The SEC has not provided any more guidance since its 8-K FAQs about the point at which consideration of, or a discussion about, a resignation ripens to a disclosable event.

3. **Who the NEOs are is now absolutely clear.** In response to commenters, the SEC has clarified in Instruction 4 to Item 5.02 that the named executive officers are those who were the NEOs in the most recent filing that required Item 402(c) disclosure. To the extent there was confusion about whether someone became an NEO any sooner than that (e.g., after the end of the year but before the proxy statement was filed), that has been resolved.

4. **Don't worry about agreements with non-named executive officers.** Agreements with executive officers who are not NEOs will not – for Form 8-K purposes - even have to be considered for purposes of determining whether they are "immaterial in amount or significance." Remember, though, they still need to be considered when determining which exhibits to file with periodic reports.

5. **Cash plans and equity plans are on equal footing**. Under the FAQs that applied to the former rules, options awarded to NEOs that were pursuant to plans and award agreements previously disclosed did not require separate disclosure on Form 8-K. The FAQs were silent as to cash awards. Under the new rules, awards of either cash or equity that are materially consistent with previously disclosed terms need not be separately disclosed provided they are disclosed under Item 402(b) when required.

6. **Don't think that disclosure of arrangements with NEOs are a thing of the past.** Although the new rules negate the Item 601(b) presumption that **any** contract or arrangement with an NEO is material, you are still required to disclose the entry into any "material" arrangement with an NEO, and any material amendment to an existing arrangement. Materiality determinations will still need to be made, and it is likely that prudence will dictate disclosure in any close cases.

7. **Report on Form 8-K any salary or bonus for an NEO that was not determinable when the Summary Compensation Table was last filed.** If an NEO's salary or bonus for the most recent fiscal year has not yet been determined when the company files its proxy statement (or Form 10-K), the company must say so in a footnote to the Summary Compensation Table and later, when the omitted amount is determined, file an 8-K to update the affected columns of the table (including the "total compensation" column). So, when salary or bonus information is omitted from the Summary Compensation Table, make sure controls and procedures are in place to get an 8-K filed once the amounts are finalized.

Tackling the Summary Compensation Table Redux

Speakers:
Mark A. Borges – Compensia
W. Alan Kailer – Hunton & Williams
Laura Thatcher – Alston & Bird

Discussion Items of Interest:

1. Section 162(m) "Performance-Based" Bonus Plans – Which Column to Use?

Under the new rules, the "Bonus" column of the Summary Compensation Table is pretty lonely. It is generally reserved for purely discretionary bonuses or service-based cash awards, such as retention bonuses. Most other annual cash awards are to be reported in the "Non-Equity Incentive Plan Compensation" column.

An issue sometimes arises in the case of incentive compensation plans that follow the "plan within a plan" design for Section 162(m) purposes, where negative discretion is used to cut back an artificially high Section 162(m) "performance-based" award. For example, the objective performance criteria for Section 162(m) purposes might be very straightforward – such as having positive net earnings – which results in a very high "maximum bonus." The plan contemplates that the Compensation Committee will in all cases exercise its negative discretion to pay a much lower actual bonus, typically based on the assessment of other performance criteria. This allows the Committee flexibility to introduce subjective analysis into the bonus determination while preserving the tax deduction under Section 162(m).

- If the Committee uses absolute discretion to come up with the actual bonus, should the amount be reflected in the Non-Equity Incentive Plan Compensation column or in the Bonus column of the Summary Compensation Table?

In many cases the Committee's negative discretion is "informed" by performance-based metrics rather than being purely subjective.

- Should the award be bifurcated, so that any purely discretionary portion is reported in the Bonus column and the more objective performance-based portion is reported in the Non-Equity Incentive Plan Compensation column?

Q&A 119.02 states that "Further, amounts earned under a plan that meets the definition of a "non-equity incentive plan," but that permits the exercise of negative discretion in determining the amounts of bonuses, generally would still be reportable in the Non-equity Incentive Plan Compensation column (column (g)). The basis for the use of various targets and negative discretion may be material information to be disclosed in the Compensation Discussion and Analysis."

- In what situations would this "general" guidance not be applicable?

2. Reporting the Assumptions Used in Valuing Reported Stock Awards

Many of the SEC Staff comment letters asked for disclosure of the assumptions used in the reported expense numbers for full-value stock awards. Unlike stock options, full-value awards do

not involve valuation assumptions (such as stock price volatility, dividend yield, risk-free interest rate, and expected life). The expense for full-value awards is generally determined by reference to the grant-date market price of the underlying stock.

- Are there any "assumptions" to be disclosed in connection with a full-value stock award?

- If an award does not pay/accrue dividends or dividend equivalents, make sure the fair value calculation reflected in the table takes this into account by backing out the portion of the stock price that is attributable to the market's expectation that the stock will pay dividends.

3. Dividend Equivalents on RSUs

Item 402(c)(2)(ix)(G) requires disclosure in the "All Other Compensation" column of the Summary Compensation Table of the dollar value of any dividends or other earnings paid on stock options or stock awards, when those amounts *were not* factored into the grant date fair value reported in the Stock Awards or Option Awards columns. The reported fair value of a stock award (i.e., the grant-date stock price) already takes into account the market's expectation that the stock may pay dividends. Therefore, there is no need to report the value of dividends or dividend equivalents under the "All Other Compensation" column when they are paid.

However, where you have an RSU that accumulates dividend equivalents and "reinvests" them in the form of additional RSUs that themselves have dividend equivalent rights, you quickly build up second and third generation RSUs.

- What is the proper method for reporting the acquisition of such later-generation RSUs acquired upon the reinvestment of dividend equivalents? Presumably the expense for such later-generation RSUs will be included in the Stock Awards column. Should they be reported as new grants in the Grants of Plan-Based Awards Table?

- If such later-generation RSUs are not themselves reported as separate awards, what is the proper method for reporting dividend equivalents earned on them? Should they be reported in the "All Other Compensation" column?

4. Disclosing Assumptions for Stock Options

What is the preferred approach for disclosing stock option valuation assumptions?

- Separate grant-by-grant chart

- Reference to financial statement footnotes as specified under the Instruction to Item 402(c)(2)(v) and (vi)

- If using the footnote reference approach – the SEC Staff confirmed in Q&A 119.04 that the disclosure about assumptions must cover the footnote in each year's financial statements in which an award occurred that was expensed during the most recent fiscal year. This means that if more than three years of awards are reflected in the Option Awards column for the most recent fiscal year, the company may need to reference multiple Forms 10-K.

5. Reporting Forfeitures and Compensation Expense Reversals

As part of the required disclosure of stock options and other equity awards in the Summary Compensation Table, the Instruction to Item 402(c)(2)(v) and (vi) requires a company to include a footnote to its Summary Compensation Table (attached to the appropriate column) describing for each named executive officer all of the forfeitures during the last completed fiscal year. In at least one SEC Staff comment letter, a company was requested to disclose in the Summary Compensation Table, the value of an NEO's forfeited equity awards. The footnote to the Summary Compensation Table should also indicate whether or not the company subtracted these amounts when calculating the values reported in Option Awards and Stock Awards columns. (This amount should be reported in dollars, rather than in number of shares.)

When an NEO leaves a company holding unvested equity awards (or, in the case of a performance-based award, fails to satisfy the performance conditions), this event has two potential consequences for the Stock Awards and Option Awards columns of the Summary Compensation Table. First, to the extent that compensation expense has been previously disclosed in the Summary Compensation Table, that amount is to be deducted in the period during which the award is forfeited. Second, the company is to report, by means of a footnote to the appropriate column, the value of the forfeited award. These may not necessarily be the same number.

- **Example**: Take a service-based restricted stock award with a grant date fair value of $100,000 that vests in full at the end of four years ("cliff" vesting). In years one and two, 25% of the award's grant date fair value would be recognized each year for financial reporting purposes, and also reported in the Summary Compensation Table. If the NEO terminates his or her employment in year three, the previously recognized compensation expense is reversed, both for accounting and reporting purposes, meaning that the company would deduct $50,000 from the amount to be reported in the Stock Awards column for year three. In addition, the company would also need to disclose in a footnote to this column that the NEO forfeited an equity award with a value of $100,000.

It seems that the same approach would be applied to a performance-based award, although the reporting years for the reversal and the forfeiture may be different.

- **Example**: Take a performance-based stock award with a grant date fair value of $100,000 where the likelihood that the performance condition will be achieved is probable at the date of grant. As long as that probability remains constant, the award will be expensed (and this amount reported) over the performance period. However, if the probability of achievement decreases, the company may need to reverse some of the previously-recognized (and reported) expense in the year when this re-evaluation occurs. However, forfeiture of the award will probably only take place at the end of the performance period, when the outcome is determined. (Query whether the failure to achieve the original probable performance target would result in a reportable "forfeiture" of the unrealized amounts.)

- When monitoring equity awards for reporting purposes, a company needs to be sensitive to the reporting implications of forfeitures, as well as compensation expense reversals. Are companies reporting award forfeitures in the Summary Compensation Table (as opposed to the termination and change in control disclosure)?

6. Reporting Compensation Deferrals

Many companies permit their executives to defer receipt of some or all of their annual compensation. When a named executive officer elects to defer a portion of his or her pay, does the deferral have to be noted in the Summary Compensation Table?

There appears to be some confusion about what is required here. When the new rules were introduced in January 2006, the SEC did, in fact, propose that companies attach a footnote to the appropriate Summary Compensation Table column indicating the portion of the amount being reported that had been deferred (see Proposed Instruction 4 to Item 402(c)). This proposal was consistent with the former rules, which required elective deferrals to be included in either the Salary or Bonus column, as appropriate (see Instruction 1 to former Item 402(b)(2)(iii)(A) and (B)).

However, at the adoption stage, responding to concerns that the disclosure could lead to "double counting," this proposed requirement was dropped (see footnote 144 and the accompanying text in the Adopting Release). While the Commission expanded the reporting requirement to cover any compensation amount (not just salary or bonus) that was otherwise payable but had been deferred (whether on a mandatory or elective basis), footnote itemization of the deferrals isn't necessary.

Still, some companies disclose these amounts on a voluntary basis; primarily to coordinate with the amounts being reported in the Nonqualified Deferred Compensation Table. The practice that appears to be developing is

- disclose in a footnote to the appropriate column of the Summary Compensation Table the amounts that were deferred for the last completed fiscal year,
- aggregate these amounts in column (b) of the NQDC Table, and
- disclose in a footnote to the NQDC Table the extent to which the amounts reported in column (b) were also reported in the Summary Compensation Table.

The third step largely repeats the first step - just in a different location and, most likely, on an aggregated, rather than an itemized, basis. So far, this approach hasn't raised any problems - either with the SEC Staff or investors, so it may become more popular next year.

7. Perquisite Disclosures

Some perks present disclosure challenges.

- **Example**: As part of a relocation policy, the company buys the executive's former residence at its appraised value. Should that be an Item 402 perk disclosure or an Item 404 related person disclosure, or both? If it is reported under Item 402, what is the incremental cost to the company if it is buying the house at 100% of the appraised value?

The disclosure rules impose a presumption that "relocation" benefits are perks even if they are broad-based, because they are likely to be operated in a discriminatory manner in favor of executives.

Therefore, if the company's relocation policy has various other elements (such as payment of moving expenses or a moving allowance, for example), those would presumptively be perks and the company would disclose its incremental cost of providing those. But as to the element of the

program that provides that the company will purchase the employee's home at the *then-appraised value*, there may be two reasonable ways to look at it. Either:

- There is no compensatory element and the repurchase is therefore not viewed as a perk, but rather a related person transaction under Item 404; OR

- It is a perk in the sense that it is only done in the context of the employment arrangement and is not "directly and integrally related to the provision of services." In that case, you would disclose the "incremental cost" to the company of that perk. If the company engages a real estate firm to handle the purchase and/or if the company covers the closing costs, those are incremental costs that should be disclosed. But beyond that, it may be reasonable to conclude that there is no incremental cost to the company where it is paying the current appraised value for the house and getting back something of exactly that value.

- A third approach, which is probably best, is to describe the transaction under Item 404 and footnote the All Other Compensation column to the Summary Compensation Table with a cross-reference to the Item 404 disclosure.

Here is a sampling of companies taking different approaches:

- AMR Corp (Item 402 only)
- Sears (Item 402 only)
- Applied Materials (Item 404 only, but Summary Compensation Table has a reference over to the 404 disclosure)
- Ingersoll Rand (Item 404 only, but Summary Compensation Table has a reference over to the 404 disclosure)
- Iberiabank Corp (Item 404 only)

8. Cash Out and Acceleration of Equity Awards in a CIC

One of the more interesting items that is reportable in the All Other Compensation column of the Summary Compensation Table are amounts paid or accrued in connection with termination of employment and change in control plans or arrangements as required by Item 402(c)(2)(ix)(D). Generally, the items that need to be part of this disclosure include the value of stock options and other equity awards that had their vesting accelerated as a result of the reportable transaction (valued on the basis of their intrinsic, rather than their SFAS 123(R), value at the time of the transaction).

A couple of related questions have come up: The first arises where, in connection with the triggering event (typically, an acquisition where the target company remains an Exchange Act reporting company), the equity awards are cashed out as part of the transaction. If the compensation expense for the awards has not already been fully reported in the Summary Compensation Table (in either the Stock Awards or Option Awards column, as appropriate), there's a question as to where to report the amount received in exchange for the award – the Stock or Option Awards column, the All Other Compensation column, or both?

There appear to be various ways to report this transaction. Under one approach, the portion of the cash out payment that equals the award's remaining (and previously unreported) compensation expense would be reported in the Stock Awards or Option Awards column, as appropriate, and

the rest (if any) would be reported in the All Other Compensation column as an amount paid or accrued in connection with a change in control of the company, with a footnote explaining the transaction and the full amount of the cash out. This approach ensures that the full payment appears in the Summary Compensation Table and avoids the potential "double counting" that could result from treating the compensation expense disclosure and the change in control payment disclosure as separate and discrete items.

Another approach would be to disclose the cash out payment in full in the All Other Compensation column, using a footnote to the Stock Awards or Options Awards column, as appropriate, to indicate the amount that would have been disclosed in this column had the portion of the payment representing compensation expense been reported here, explain why it was not included, and refer to the related disclosure in the All Other Compensation column.

A third approach would sidestep the Summary Compensation Table altogether; instead reporting the cash out payment in the Option Exercises and Stock Vested Table (essentially equating the payment to a cash-settled SAR).

It's this third approach which dovetails with the second question – which is, whether this type of payment or the intrinsic value of equity awards that have their vesting accelerated as the result of a termination of employment or a change in control needs to be reported in the Summary Compensation Table. Do these payments have to be reported? After all, they're compensation-related amounts that appear to be within the scope of Item 402(c)(2)(ix)(D).

However, when the SEC revised the disclosure rules in December 2006, it made a policy decision that equity awards are to be reported in the Summary Compensation Table exclusively on the basis of their SFAS 123(R) value. Thus, if an award is cashed our or a termination of employment or change in control accelerates the vesting of outstanding equity awards, only the previously-unreported SFAS 123(R) compensation expense (if any) would need to be reported in the Stock Awards or Option Awards column, as appropriate. Following this logic, any intrinsic value realized as a result of the acceleration would be reported elsewhere (such as the Option Exercises and Stock Vested Table), but wouldn't need to be included in the Summary Compensation Table.

This conclusion appears to be supported by the rules themselves as Item 402(a)(2) states that "[n]o amount reported as compensation for one fiscal year need be reported in the same manner as compensation for a subsequent fiscal year." Thus, once the grant date fair value of an equity award has been fully reported in the Summary Compensation Table, the award doesn't need to be reported in the table again when it's cashed out or its vesting is accelerated (this is essentially the same reasoning that justifies excluding options and other equity awards from the Summary Compensation Table when they're exercised or vest).

While this argument has some appeal, it's not clear whether the rules were intended to apply this way. As you know, the cited sentence goes on to say that "amounts reported as compensation for one fiscal year may be required to be reported in a different manner pursuant to this Item." In addition, the initial portion of the cited sentence includes the phrase "reported in the same manner." Arguably, reporting equity awards in the Stock or Option Awards columns represents a "different manner" from reporting the awards in the All Other Compensation column as part of a severance arrangements or a corporate transaction. If you agree with this interpretation, then there appears to be some basis for including a cash out payment or the intrinsic value of

accelerated awards (at least to the extent this amount exceeds the remaining compensation expense being reported for the award) in the Summary Compensation Table.

At the end of the day, there may not be a clear answer here. Apparently, these considerations explain why we see so many companies exclude the value of accelerated vesting from their Item 402(c)(2)(ix)(D) disclosure (perhaps these omissions are not unwarranted). Our view is that these amounts should be reported in the All Other Compensation column of the Summary Compensation Table, but we may need to get some clarification from the SEC Staff on whether it has a disclosure preference (or whether there are straightforward answers to these questions).

9. Bonus Payable in Stock

Several questions have arisen regarding the proper reporting where a bonus opportunity is initially denominated in cash (such as a percent of salary) but is subsequently paid in an equity form. The JCEB posed various hypothetical arrangements to the SEC Staff in its May 8, 2008 Q&A. Here's where that led:

<table>
<tr><td colspan="4">Bonus opportunity stated as a dollar amount. At the end of the performance period, Company decides to pay in:</td></tr>
<tr><td colspan="2"></td><td>SCT</td><td>GPBAT</td></tr>
<tr><td>a</td><td>fully-vested stock</td><td>uncertain [1]</td><td>uncertain [1]</td></tr>
<tr><td>b</td><td>time-vesting restricted stock or RSUs payable in stock</td><td>uncertain [1]</td><td>uncertain [1]</td></tr>
<tr><td>c</td><td>time-vesting phantom stock or RSUs payable in cash</td><td>uncertain [1]</td><td>uncertain [1]</td></tr>
</table>

[(1)] JCEB suggested that the bonus be reported as non-equity incentive compensation in the SCT and the GPBAT, since the right to receive equity was not embedded in the award at grant. JCEB pointed out similarity to Q&A 4.03 of the Staff's guidance on S-K Item 402, relating to an election by the executive to convert a cash bonus to equity.

<table>
<tr><td colspan="4">Bonus opportunity stated as a dollar amount. At the time of establishing the bonus opportunity, Company determines that the dollar amount of bonus earned will be converted into (based on stock price at the time of conversion):</td></tr>
<tr><td colspan="2"></td><td>SCT</td><td>GPBAT</td></tr>
<tr><td>d</td><td>fully-vested stock</td><td>stock award [1]</td><td>equity incentive plan award [1] [2]</td></tr>
<tr><td>e</td><td>time-vesting restricted stock or RSUs payable in stock</td><td>stock award [1]</td><td>equity incentive plan award [1] [2]</td></tr>
<tr><td>f</td><td>time-vesting phantom stock or RSUs payable in cash</td><td>stock award [1]</td><td>equity incentive plan award [1] [2]</td></tr>
</table>

[(1)] These are equity incentive plan awards since they are covered by SFAS 123(R).
[(2)] It is permissible to change the GPBAT column heading to show potential payment in dollars rather than number of shares

10. Periods Covered by Footnotes

In some situations, such as with Instruction 3 to Item 402(c)(2)(vii) (regarding the quantification of the annual pension value change and above-market or preferential earnings on nonqualified deferred compensation), the new rules specifically state that the footnotes to the Summary Compensation Table need only apply to compensation for the last completed fiscal year. In other instances, Item 402(c) does not specify whether footnoted information must be provided with respect to just the last completed fiscal year, or for all three covered fiscal years required in the Summary Compensation Table.

In Q&A 119.14, the SEC Staff states that, where an instruction to the Summary Compensation Table does not specifically limit footnote disclosure to compensation for the last completed fiscal year (as is the case with Instructions 3 and 4 to Item 402(c)(2)(ix)), footnote disclosure for the other covered fiscal years included in the table is required only if the information is material to an investor's understanding of the compensation reported in the Summary Compensation Table for the last completed fiscal year.

- What considerations should a company assess in deciding how to use footnotes in 2009, the first year that the Summary Compensation Table will cover three years?

11. Directors Fees Received by NEO

There's some question as to where in the Summary Compensation Table director fees received by a NEO should be reported, as required by Instruction 3 to Item 402(c). It seems that this information should go in each of the corresponding columns in the Summary Compensation Table, but Instruction 3 seems to contemplate one footnote that covers all such compensation, irrespective of classification.

It appears that what is contemplated is that a company should include the compensation in the appropriate column (*i.e.*, "Salary," "Stock Awards," "All Other Compensation") and then indicate by footnote how much director compensation is being reported, referencing the specific categories identified in the columns of the Director Compensation Table. A single footnote is not necessary, as the company may footnote the designated numbers in each column and provide the detail individually for those numbers.

12. Retention Bonus

Interesting disclosure issues arise in the context of retention bonuses. In May 2008, the JCEB posed this hypothetical to the SEC Staff:

- In 2008 a company enters into retention agreements with certain executives under which it agrees to pay a cash retention bonus if the executive remains in employment until a specified date in 2010. What, if anything, is reportable in the proxy statement for 2008 with respect to this arrangement? Is the analysis different if the retention bonus will be credited with earnings during the retention period?

SEC Response: The retention bonus should be reported in the Summary Compensation Table only when the employment or performance necessary to earn the bonus has been completed – that is when the bonus is deemed "earned." If the employment condition for payment of the bonus is not satisfied until 2010, the bonus would be reported for 2010. However, if the executive became entitled to a portion of the bonus by virtue of employment through 2009, that portion of the bonus would be reportable in the Summary Compensation Table for 2009. If there was an earnings

component to the bonus (for example, if the bonus amount would also be credited with earnings at the "prime rate") the earnings would be reportable when the performance necessary to earn them was complete. Thus the earnings would be reportable at the same time as the related bonus, assuming the earnings are not payable unless the bonus is paid. However if the executive will be entitled to keep the earnings whether or not he/she earns the bonus, then the earnings should be reported each year as they are earned. A retention bonus that requires future service as a condition of payment (and that is not deferred after such service has been completed) would not be reported in the Deferred Compensation Table.

13. Pension Value for Newly Hired NEO with Vested Pension Benefit

Item 402(c)(2)(viii)(A) requires companies to disclose the aggregate change in the actuarial present value of their NEOs' accumulated benefits under all defined benefit and actuarial pension plans from the pension plan measurement date used for financial statement reporting purposes for the prior completed fiscal year to the pension plan measurement date used for financial statement reporting purposes for the covered fiscal year.

In calculating the change in pension value as disclosed in the Summary Compensation Table, Instruction 1 to Item 402(c)(2)(viii) states that the company should use the same amounts required to be disclosed pursuant to paragraph (h)(2)(iv) (actuarial present value of pension benefit) of Item 402 for the covered fiscal year and the amounts that were "or would have been required" to be reported for the executive officer pursuant to paragraph (h)(2)(iv) for the prior completed fiscal year.

- Assume that a NEO is newly hired in 2007, and based on his employment agreement, the NEO has a vested pension benefit at the time of hiring. What is the actuarial present value of the pension benefit for 2006? Should the company assume that the new executive officer was an employee at the end of 2006 and compute the actuarial present value of the pension benefit based on that assumption or would the actuarial present value for 2006 be zero?

- Probably should not report any change in pension value from 2007 over 2006, given that the NEO was not employed and did not have any accrued pension benefits as of the pension measurement date in 2006. Reporting the entire amount as a change would skew the Summary Compensation Table results. A company must still disclose the accumulated benefits in the 2007 Pension Benefits Table, so the fact that the executive officer has the vested pension benefit (along with any necessary disclosure in the CD&A or elsewhere in the accompanying narrative discussion) would make that situation clear enough to investors.

Moody's Corporate Governance

Special Comment

July 2008

Expanded Disclosure On U.S. Executive Compensation Offers New Clues For Creditors

Table of Contents:

Overview	**1**
Analysis	**2**
Performance metrics and targets	**2**
Peer groups	**3**
Severance following change in control	**3**
Other useful disclosures	**3**
Internal pay equity	3
Wealth accumulation	4
Future compensation disclosure challenges	**4**
Moody's Related Research	**5**

Analyst Contacts:

New York 1.212.553.1653

Christian Plath
Assistant Vice President

Mark LaMonte
Senior Vice President – Head of Enhanced Analytics Group

Overview

Executive pay is incorporated into Moody's credit analysis of rated issuers because compensation can be a determinant of management behavior that affects indirectly credit quality. In 2007, U.S. public filers had to comply for the first time with substantially altered and expanded Securities and Exchange Commission (SEC) rules on required disclosure of executive compensation. In April 2007, Moody's published a detailed "user's guide" to these new rules.[1]

Based on a review of 350 of the proxy statements filed in 2007, the SEC has made clear that it expects improved compliance in 2008 with the new rules in several key areas.[2] The SEC found deficiencies in some areas that are particularly useful to credit analysis: 1) disclosure of performance metrics and targets; 2) peer groups used to benchmark pay; and 3) payments following a change in control.

Moody's believes that well articulated performance targets provide insight into the aggressiveness and risk profile of a company. Peer group selection reveals how a company perceives itself, and whether the board is exercising disciplined oversight of pay benchmarking in particular. Finally, change in control payouts and terms provide insight into the incentives (or lack thereof) management teams may have for pursuing strategic alternatives that can be transformative events for creditors, such as business combinations.

[1] A User's Guide to the SEC's New Rule for Reporting Executive Pay, April 2007 (102762)
[2] SEC Staff Observations in the Review of Executive Compensation Disclosure (SEC Website)

Moody's Investors Service

This report discusses why these cited areas are important to credit quality, what the SEC has said about them, and the red flags that investors should consider when evaluating these compensation elements under the new disclosure rules. Moody's plans to follow this report with comments on compensation trends and Supplemental Executive Retirement Plans (SERPs).

Analysis

Performance metrics and targets

Understanding the performance metrics and targets that drive incentive pay is useful to credit analysis because:

- Performance metrics are a window into management decision making
- Performance targets are a guide for risk tolerance
- Managers may be inclined to pursue strategies that maximize payouts under incentive plans

Pay metrics create incentives for executives to engage in behavior that can be either beneficial or detrimental to creditors, depending on the metric. Incentive pay metrics tied to cash flow or return on investment, for example, are generally good for creditors, because they provide an incentive to maximize funds available to service debt. However, metrics tied to earnings per share (EPS), for example, might put excessive focus on share repurchases, or debt-funded acquisitions aimed at revenue growth, management decisions not always as favorable to creditors.[3]

Disclosure of the actual numerical targets can be a useful indicator of the board's risk tolerance. The actual targets are useful in understanding how aggressive management will need to be to achieve the target. The targets are also a useful measure of how difficult it will be for managers to achieve the maximum payouts.

Quality disclosure of performance metrics and targets facilitates better insight into management decision-making because it illustrates the behavior the board wants to see from management. In that vein managers will pursue strategies in order to maximize their performance payouts.

Continuing a battle that pre-dates the new rules, the SEC is pushing issuers to provide more detailed disclosure regarding the financial metrics and targets used to calculate annual bonus and long-term incentive pay for named executives. Under the new rules, issuers are required to disclose targets used to calculate pay. If they do not, they must demonstrate to the SEC that disclosure of the targets could cause the company competitive harm. Even if the targets are not disclosed, issuers are required to characterize how difficult it will be for the executive or how likely it will be for the company to achieve these targets.

Some red flags that investors may wish to consider include: too many performance metrics ("laundry list"); overly complicated metrics; or lack of discussion about the probability of achieving performance compensation. These red flags could be an indication of an undisciplined pay-setting process. The level of detail and discussion about executive pay in company disclosure can speak to a board's culture of openness, or lack thereof. Poor disclosure impedes the ability of investors and analysts to interpret potential implications of pay for bondholders.

That said, Moody's found that some companies did do a better job of disclosing performance metrics and targets including, for example, specific ranges for the funding measure for the annual incentive plan and specific language around measures that would reduce the overall annual incentive.

[3] U.S. Executive Pay Structure and Metrics, June 2006 (97887)

Peer groups

Improved disclosure of peer group composition provides insight into the board's process of benchmarking executive pay against appropriate peers. The SEC has made clear that it expects improved disclosure around what peer groups are used to benchmark pay when the peer group is a material factor in setting pay levels. As a result, Moody's found more issuers to have more useful disclosure regarding peer group benchmarking, though there is room for improvement among almost all issuers.

Here are some red flags to look for when assessing peer groups:

- Too many firms listed (more than 15)
- Bias toward "peers" that are substantially larger and/or more profitable
- Multiple peer groups with unusually high CEO pay, particularly if not direct competitors
- Too many industries and geographic markets included
- Peers that do not compete with the issuer for executive talent
- Unexplained year-to-year peer group changes

These red flags can be a concern to investors because of the potential to "game" the pay-setting process. For example, a company may select a peer group composed of companies that are substantially larger than itself; that set a high percentile pay target (75th percentile or greater); or that operate in a more profitable sector. This practice can indicate an undisciplined pay-setting process and weak board oversight.

That said, some companies provided useful peer group disclosure in the 2008 proxy statements, including key factors about the peer group like revenues, asset size and number of employees.

Severance following change in control

Disclosure of hypothetical severance payouts to named executives under various scenarios, including following a change in control, is now required under SEC rules. This expanded disclosure may provide valuable insight into which managers have unusually strong incentives, relative to peers, to pursue a change in control such as a merger. The disclosure could be of particular interest to bondholders that do not have covenant protection against deterioration in credit quality due to a change in control, especially one that results from a debt-funded business combination. These disclosures can be especially useful when a company has shareholder activists who have targeted it for strategic changes.

Most issuers in 2007 used a tabular format to detail severance payouts to each named executive under different scenarios, including termination following a change in control. The SEC complimented the use of tables, which should help to generate even more uniform disclosure in 2008.

Other useful disclosures

Some companies provided disclosure that went beyond what was required by the rules and were useful from an analysis perspective. Two such areas were disclosures on internal pay equity and wealth accumulation.

Internal pay equity

One area of pay on which institutional investors are increasingly focused is the difference in pay between the CEO and other senior managers, sometimes referred to as "internal pay equity". This is essentially the ratio of pay between the CEO and the CEO's direct reports. A large ratio can be a possible sign of "key person risk" or a weak board.

While we do not argue that companies should set up specific pay ratios between executives we do note that at larger companies generally, the pay level for the second highest paid executive is about half of the CEO's total direct compensation. In our view, a large disparity in internal pay equity (greater than three times the amount

received by the executive second in pay, for example) may indicate underdevelopment of management succession planning, and concentration of power in the CEO. These factors pose a substantial succession planning challenge and some key person risk for the company at the CEO level. We think it is useful for boards to engage in this type of analysis as it provides a level of comfort that the board is exercising its role in succession planning and evaluation of the CEO's progress.

Although many companies review internal pay equity when determining compensation levels, companies are not required to include a discussion of internal pay ratios in the proxy statement. However, a number of companies, like ConocoPhillips, Amgen and Intel, have taken the extra step to include this type of disclosure, which is a positive step in complying with the spirit of the enhanced disclosure requirements and is useful information for compensation analysis. Each of these companies provided a brief discussion on the total pay ratios between the CEO on other named executives.

Wealth accumulation

Another area investors have voiced concern over has been the total wealth accumulation of named executives, especially the CEO. We believe it is useful for compensation committees and boards to engage in a discussion about the total amount of wealth transfer given to an executive, commonly referred to as the "tally sheet". A long tenured CEO, for example, may have accumulated a significant amount of equity. This can call into question the need for further large equity grants as a motivational factor. It is also helpful for the investor to understand the value transfer, and investors gain comfort from disclosure that these issues are raised in the compensation committees. A number of companies, including Kellogg and DuPont, have disclosed the board discussion around tally sheets.

Future compensation disclosure challenges

One of Moody's original concerns about the enhanced disclosure rules, echoed by the SEC, was that the legal burden attributed to filing the Compensation Discussion and Analysis (CD&A) would encourage companies to veer towards legalese and boilerplate disclosures. Overall we believe there is room for further improvements in the conciseness of the CD&As and embrace of "plain English". That said, we did see improved disclosure in the 2008 proxy statements in certain areas helpful to credit analysis.

Moody's Related Research

Special Comment:

- Western European Executive Pay Disclosure Trends Bode Well for Better Credit Analysis, December 2007 (105837)
- Analyzing Unexpected CEO Departures and Severance Payouts for Signs of Weak Governance, December 2007 (105930)
- A User's Guide to the SEC's New Rules for Reporting Executive Pay, April 2007 (102762)
- U.S. Executive Pay Structure and Metrics, June 2006 (97887)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Expanded Disclosure On U.S. Executive Compensation Offers New Clues For Creditors

Report Number: 109705

Authors	Production Associate
Drew Hambly	Fabian Alvarez
Christian Plath	

© Copyright 2008, Moody's Investors Service, Inc. and/or its licensors and affiliates (together, **"MOODY'S"**). All rights reserved. **ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.** All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Moody's Investors Service

DENISE L. NAPPIER
TREASURER

State of Connecticut
Office of the Treasurer

HOWARD G. RIFKIN
DEPUTY TREASURER

May 12, 2008

The Honorable Christopher Cox, Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox:

As a coalition of 21 institutional investors representing $1.4 trillion in assets, we write today to bring to your attention our concern about the need for greater disclosure in the area of compensation consultant independence.

Investors need sound information in order to make prudent decisions, including information that will allow investors to assess the independence of the compensation consultant engaged by the board compensation committee. We believe a potential conflict of interest exists at companies in which consultants are hired to do work for both a company's management and its compensation committee. When a consultant performs such services as benefits management on the one hand, and advises the board's compensation committee on executive pay matters on the other hand, we believe that the consultant's integrity may be jeopardized. We refer you to the enclosed detailed comments.

Therefore, we are asking the Commission to consider requiring companies to disclose in the proxy statement the fees associated with all engagements for a single company and any ownership interest a consultant working for the compensation committee may have in the parent consulting firm.

We are also requesting a meeting with you and other Commissioners to discuss this issue. It is our belief that you are as committed to the idea of compensation consultant independence as we are, and we are eager to meet with you to explore ways we, as shareholders, and you, as a regulation commission, can bring about this desired goal.

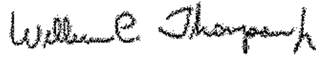
We are available to meet with you at your convenience to discuss these issues further. Please contact Meredith Miller, Assistant Treasurer for Policy, Office of the Connecticut State Treasurer (860) 702-3294.

Thank you.

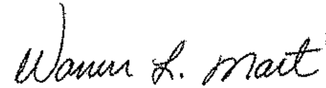
Sincerely,

Denise L. Nappier Treasurer State of Connecticut	Richard H. Moore Treasurer State of North Carolina	Thomas P. DiNapoli Comptroller State of New York

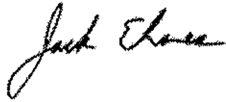
Nancy Kopp
Chairman
Board of Trustees
State Retirement and
Pension System of Maryland



William C. Thompson, Jr.
Comptroller
City of New York

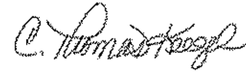


Warren Mart
Co-Chairman, Board of
Trustees
I.A.M. National Pension Fund
General Secretary-Treasurer
IAMAW

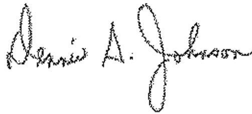


Jack Ehnes
CEO
CalSTRS

Colin Melvin
CEO
Hermes Equity Ownership
Services Limited

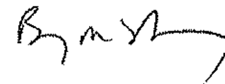


C. Thomas Keegel
General Secretary-Treasurer
International Brotherhood of
Teamsters

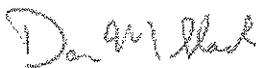


Dennis A. Johnson
Senior Portfolio Manager
CalSTRS

William Atwood
Executive Director
Board of Investment
State of Illinois



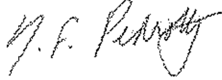
Barry McAnarney
Executive Director
Central Laborers' Pension,
Welfare & Annuity Funds



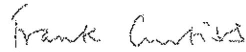
Dan Slack
Executive Director
Illinois State Universities
Retirement System

Stephen Abrecht
Director
SEIU Master Trust

Mike McCauley
Senior Corporate Governance
Florida State Board of
Administration

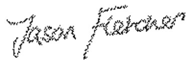


Dan Pedrotty
Director, Office of Investment
AFL-CIO Reserve Fund

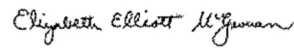


Frank Curtiss
Head of Corporate Governance
Railpen Investments

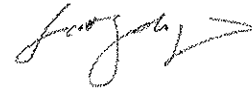
Tim Smith
Senior Vice President
Walden Asset Management



Jason Fletcher
Head of Americas Equities
Universities Superannuation
Scheme Ltd



Elizabeth McGeveran
Senior Vice President
Governance and Sustainable
Investment
F&C Management Ltd



Scott Zdrazil
Vice President
Director of Corporate
Governance
Amalgamated Bank

Attachment

Detailed Comments on Compensation Consultant Independence

The following comments are submitted in support of the May 12, 2008, letter from a coalition of institutional investors and their representative bodies with assets under management exceeding $1.4 trillion.

Background

The work of board compensation committees is scrutinized closely by investors, proxy advisors and the media, as directors attempt to find a balance between the pressure to avoid excessive pay embarrassments and the demand that valued executive talent be attracted and retained. The complexity of compensation plans and programs, including the interaction among plans and debates over appropriate metrics and hurdles, adds to the challenges facing compensation committees.

Compensation consultants now play a key role in the pay-setting process by anchoring the committees' deliberations through data on peer group companies and by recommending pay arrangements. Use of an outside consultant has become more the norm than the exception. According to a recent study by The Corporate Library, 51% of companies in the Russell 3000 index that filed proxy statements in February through May of 2007 identified a specific compensation consultant that provided services to the compensation committee, with additional companies reporting that a consultant was used but not identifying it by name.[1] An even larger proportion of Fortune 250 companies—over 77%--disclosed retaining a compensation consultant in 2007 proxy filings, according to a December 2007 study by the House Committee on Oversight and Government Reform ("Oversight Committee Study").[2]

Potential Conflicts of Interest

With companies' reliance on compensation consultants, investors are concerned that the advice provided by these consultants may be biased as a result of potential conflicts of interest. Most firms that provide compensation consulting services also provide other kinds of services, such as benefits administration, human resources consulting and actuarial services. The Oversight Committee Study documented that it is common for a firm to be engaged to provide other services at companies where the firm advises on executive compensation: such arrangements were found at 113 of the Fortune 250 companies included in the study. A dramatic difference was found in the revenues generated by these activities, which are much more lucrative than compensation consulting. On average, $2.3 million was received for other services at these companies while $220,000 was received for compensation consulting while, a ratio of approximately 11 to 1. At 27 companies, the ratio was more than 20 to 1.[3]

---

[1] Alexandra Higgins, "The Effect of Compensation Consultants: A Study of Market Share and Compensation Policy Advice," at 2 (The Corporate Library Oct. 2007).

[2] United States House of Representatives, Committee on Oversight and Government Reform, "Executive Pay: Conflicts of Interest among Compensation Consultants," at 4 (Dec. 2007).

[3] Id.

Even more troubling, the Oversight Committee Study found that companies using consultants with the most acute potential conflicts of interest (as measured by the fee ratios) reported median compensation of $12.5 million for 2006, 67% higher than the median compensation of $7.5 million paid to companies whose consultants did not have conflicts of interest. A similar, though less striking, correlation was found when comparing compensation at all companies using conflicted consultants (regardless of the disparity in the fee ratio) against compensation at companies using non-conflicted consultants.[4]

Some consulting firms argue that they manage such conflicts by tying the pay of compensation consultants only to the fortunes of the compensation consulting unit and not to other units in the firm that might seek to provide services to the same companies. We believe that these kinds of measures are inadequate because they ignore the fact that compensation consultants may own equity interests in the firm and thus benefit from non-compensation-consulting engagements landed by the firm. Testimony by James Reda, founder and managing director of James F. Reda & Associates, before the House Committee on Oversight and Government Reform at a December 2007 hearing on the link between compensation consultant independence and executive pay underscores the internal conflict arising for compensation consultants with an equity stake in their consulting firms when the firms do other business for the company:

> [T]hese consultants are part of a bigger organization. They hold stock in the actual organization that they're a member of. So, depending on how well they do selling…the more they sell, the more they earn their retirement and increase their wealth.
>
> [T]hese Chinese walls and firewalls do not work because of the economic interest of the [compensation consultants] who work for [the consulting] firm—they are essentially tied at the hip economically, and it's impossible to break that tie.[5]

In its 2006 rulemaking revamping disclosures around executive compensation, the Commission recognized the important role played by consultants, stating that the "involvement of compensation consultants and their interaction with the compensation committee is material information that should be required." To that end, the rules adopted in 2006 require companies to disclose:

> any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether such consultants are engaged directly by the compensation committee (or persons performing the equivalent functions) or any

---

[4] Id. at 6.

[5] United States House of Representatives, Committee on Oversight and Government Reform, Hearing on Executive Pay: The Role of Compensation Consultants (December 5, 2007), at 123-124.

other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.[6]

Problems with Current Disclosure Rules

The current rules do not, however, compel companies to disclose the information necessary to assess whether compensation consultants are independent. Specifically, companies do not have to reveal (a) fees paid for services provided to the compensation committee, (b) whether any firm providing compensation consulting services was engaged to perform other services for the company, management or any named executive officer; or (c) if it was, how much the firm was paid for providing such other services. The current rules also do not require disclosure of any ownership interest an individual compensation consultant providing services to the board has in the firm as a whole.

During the 2006 rulemaking process, a significant number of commentators, including many large U.S. and foreign investors, urged the Commission to expand the proposed disclosure on compensation consultants to include disclosure of other engagements and related fees.[7] These commentators argued that the independence of the compensation consultant matters a great deal to investors in evaluating the work of the compensation committee, especially in light of the fact that companies often promote the consultant's independence in their proxy statements. The Commission's final rule did not incorporate these suggestions.

The Case for Fuller Disclosure

Since the 2006 rulemaking, the case for disclosure of other engagements and fees has become even more compelling. The Oversight Committee Study has only increased the concern investors have about the effect of conflicted compensation advice. In addition to the findings discussed above, the Oversight Committee Study found that 30 companies described their consultants as "independent" in their proxy statements even though those consulting firms performed other work for the companies. The fact that the Oversight Committee Study, which to our knowledge was the first to examine compensation consultant conflicts of interest, was entirely dependent upon the power of the committee's chairman to obtain non-public data regarding these matters highlights the gaps in the current disclosure requirements.

---

[6] Item 407(e) of Regulation S-K, 17 C.F.R. section 229.407(e).

[7] See, e.g., comment letters from a group of institutional investors, including CalPERS, CalSTRS, Florida State Board of Administration, New York State Common Retirement System, New York City Pension Funds, PGGM, ABP, Hermes, Universities Superannuation Scheme, UniSuper, London Pensions Fund Authority, F&C Asset Management, Co-operative Insurance Society, Illinois State Board of Investment, Ontario Teachers Pension Plan, Public Sector and Commonwealth Super, and Railpen Investments (Apr. 10, 2006); CFA Institute for Financial Market Integrity (Apr. 13, 2006); Denise Nappier, Connecticut State Treasurer (Apr. 10, 2006); Michelle Leder (Apr. 13, 2006).

In December 2007, the CFA Institute for Financial Market Integrity—part of the CFA Institute, a global non-profit professional association representing financial analysts, portfolio managers, and other investment professionals—asked the Commission to improve its executive compensation disclosure rules by, among other things, requiring disclosure of amounts paid to a board's compensation consulting firm for other work for the company. The letter argued that such disclosure "will allow shareowners to determine whether the board's consultants are sufficiently independent from senior management with regard to executive compensation advice." [8]

A private market-based solution to this information gap is unlikely, in our view. A regulatory solution would level the playing field and enable all investors to have meaningful information about the independence of the consultant, information that we believe is as material to the quality of the advice committees rely on as the nature and scope of the assignment. We therefore urge the Commission to revisit the question of requiring proxy statement disclosure of fees associated with all engagements for a single company and any ownership interest a consultant working for the compensation committee may have in the parent consulting firm.

---

[8] See Letter from Kurt Schacht, CFA and James C. Allen, CFA to John W. White, Directors, Division of Corporation Finance, Securities and Exchange Commission, at 4 (Dec. 20, 2007) (available at http://www.cfainstitute.org/centre/topics/comment/2007/pdf/exec_comp_followup.pdf).

InvestorRelationships.com

Practical guidance for those in investor relations, shareholder services and corporate governance

Order Form

During the past year, many practitioners have come to rely upon *InvestorRelationships.com* to provide a wealth of practical guidance on issues that impact those working in investor relations, shareholder services, and corporate governance. Act today to get access to the essential guidance in the *InvestorRelationships.com* quarterly newsletter and the other resources on the website.

Membership Bonus: Act today to gain free access to the major January 14th webconference—"The SEC's New Corporate Website Guidance: Everything You Need to Know & And Do NOW." There are more details on the other side; the panels include:

- **"The SEC Staff Speaks"**
- **"How to Save Big Money By Evolving Your Earnings Release Practices"**
- **"Avoiding Liability: Applying Regulation FD Now"**
- **"Converting Your IR Web Page: Preparing for the New Annual Meeting Campaigns"**
- **"How to Draft Online Disclosure"**
- **"The Future is Here: E-Forums and Blogs"**

We urge you to try a no-risk membership for 2009 now! You can join by one of three methods: (1) by credit card online; (2) by credit card by faxing this form; or (3) by regular mail with this form.

Here are our rates:

❑ Single User—$295/year
❑ Up to 5 Users (at one location)—$495/year
❑ Single Location (unlimited number of users at one location)—$790/year
❑ Firmwide (unlimited number of users at unlimited locations)—$1495/year

Unconditional Full Refund—If at any time you are not completely satisfied with *InvestorRelationships.com*, simply tell us and we will refund the entire cost of the year's membership.

There are two ways to pay with this form:

❑ Pay by check – Enclosed is our payment of $___________ .
Please make your check payable to **Executive Press, Inc.**

To expedite processing, instead of returning this form, please use the online form at InvestorRelationships.com.

❑ Pay by Credit Card – ❑ VISA ❑ MasterCard ❑ American Express

Credit Card Number ____________________ Expiration Date ____________________

Cardholder Name ____________________ Authorized Signature ____________________

Name ____________________ Title____________________

Firm____________________ E-Mail____________________

Address____________________ Tel. No. ____________________

City/State/Zip ____________________ Fax No.____________________

Go to InvestorRelationships.com to Try a No-Risk Trial Today!

InvestorRelationships.com presents…

"The SEC's New Corporate Website Guidance: Everything You Need to Know – And Do NOW"

A Practical 'MUST' Conference featuring the Foremost Experts

Wednesday, January 14, 2009

(All panels will be archived and available at your discretion)

Now that the SEC has made dramatic changes to its guidance regarding what companies can do online, you—and every public company—will need to take advantage of the many opportunities that are now available. Pitfalls also abound as you attempt to change your ways. You simply can't afford to make mistakes—nor can you just do nothing and fall behind the curve!

During this Conference, you will be provided a roadmap—with plenty of practice pointers—of what you can now do. The panels include:

– **"The SEC Staff Speaks"**—featuring Chief Counsel Tom Kim of the SEC's Division of Corporation Finance, who will address the most frequently asked questions that practitioners are now asking. Tom is one of the primary draftsmen of the SEC's new corporate website guidance.

– **"How to Save Big Money By Evolving Your Earnings Release Practices"**—Cost-savings. Become a hero within your company by safely making the most of the SEC's new guidance.

– **"Avoiding Liability: Applying Regulation FD Now"**—Much confusion exists about what companies can now safely do. Learn when it's really appropriate to worry about Regulation FD—and when the lawyers may be overly cautious.

– **"Converting Your IR Web Page: Preparing for the New Annual Meeting Campaigns"**—During this panel, you will get step-by-step guidance—with concrete examples—of how you can leverage your IR web page to receive better results during annual meetings.

– **"How to Draft Online Disclosure"**—The future is here and the art of drafting disclosures is evolving fast. Among other skills you now need, learn how to "layer" disclosure online, how to present disclosure in summaries and how to become a usability master.

– **"The Future is Here: E-Forums and Blogs"**—Hear firsthand from those pioneers who have blogged on behalf of their companies—and who have created e-forums for shareholders to communicate.