

# Eight Ways to Prepare for the New SEC Rules

By Mark Reilly and Brian Enright, 3C Compensation Consulting Consortium

**On** Jan. 27, 2006, the Securities and Exchange Commission (SEC) issued proposed new rules for the reporting of executive compensation. The proposal makes substantial revisions and updates to the existing disclosure rules, which were issued in 1992.

Executive compensation has increasingly been headline material in the last few years. And in keeping with changes in the marketplace, the SEC is proposing to shine even more light on disclosure.

As of press time, the SEC is still accepting comment letters and is expected to issue final regulations in the next few months. But companies should begin preparing now, as the

rules would apply to the disclosure of the 2006-2007 proxy season.

This article suggests eight ways that companies can begin to prepare for the changes in executive compensation disclosure.

## QUICK LOOK

- ➔ The rationale for some benefits and perquisites may not hold under intense scrutiny, and a better approach would be to provide modest benefits and perks and an aggressive incentive program tied to performance.
- ➔ Since current rules only require the reporting of stock sales, stock pledges may reveal potential conflicts between company and shareholder interests.
- ➔ Shareholders will be looking for incentive plans with goals that exceed Wall Street expectations on growth and earnings.

## 1. Use a tally sheet to analyze total compensation levels.

One of the new buzzwords in compensation is the “tally” sheet, which is basically a spreadsheet designed to total the individual elements in order to provide a full picture of total compensation. Compensation consultants have relied on tally sheets for many years to present their analysis, but more committees are asking for additional columns on the cost of benefits, perquisites, deferred compensation, Supplemental Executive Retirement Plans (SERPS) and severance agreements.

The tally sheet shown in Figure 1 on page 60 lists the data typically gathered by outside consultants for

the compensation committee. Some of the data items are not included in the total compensation figure, such as the projected value of retirement and stock grants, and are provided to answer specific questions. The SEC's proposed summary compensation table is different from the tally sheet, since it lumps benefits and perks into "All Other Compensation." The SEC proposal requires footnote disclosure for all specific other items greater than \$10,000 (USD). The SEC also will require separate tables with more detail on retirement and performance-unit/share plans.

## **2. Reduce or try to limit the amount of total compensation not tied to performance.**

Shareholders will see the total compensation figures in the proxy statement and question any large amount of pay *not* tied to performance, especially for companies that are not performing well. One example is the \$145,000 for personal travel paid a few years ago to the chairman of a large New York bank. The rationale for these types of perks may not hold water, and a better approach is to provide modest benefits and perks and an aggressive incentive program tied to performance. Get ahead of the curve and start to make this change now.

## **3. Encourage executives not to pledge stock.**

Many executives use company stock as collateral to obtain loans or fund margin accounts that allow them to diversify their holdings. The SEC is proposing that executives disclose any company stock that they have pledged as collateral. Financial advisers encourage executives to diversify their holdings, but boards grant stock for executives to hold in order to align executive and shareholder interests. Many boards have stock ownership guidelines for their top executives. A typical practice is to require CEOs to

hold five to seven times their base salary in company stock. McDonald's requires its CEO to hold five times the salary and Campbell's Soup requires seven times the salary. Since current rules only require the reporting of stock sales, stock pledges may reveal potential conflicts between company and shareholder interests. For example, Bernie Ebbers, former CEO of WorldCom, used stock as collateral to borrow money to buy more stock. When the price started dropping, prosecutors say he manipulated WorldCom financial results to try to keep the stock price up. He was recently convicted of securities fraud, conspiracy and filing false documents with regulators.

## **4. Simplify plan design so it can be easily communicated in "plain English."**

Many companies have already taken steps to improve communication due to shareholder demand, but the SEC wants much more detail on long-term incentive (LTI) plans, retirement plans, severance plans and golden parachutes. Consider redesigning programs that are difficult to explain or justify. The plain-English requirement is expected to limit the use of technical and financial jargon when the rules are finalized.

## **5. Develop LTI programs that provide the same amount of value to executives as they cost the company.**

The new SEC rules require that the cost of long-term incentive programs, stock options and restricted stock be included in the summary compensation table as part of the effort to report total compensation. The company must use the same approach presented in the official company financial statements. For example, most companies use the Black-Scholes model to value stock options. This model produces an option cost of approximately 33 percent of the grant

price (this varies greatly by industry.) Is this the same value perceived by executives? If not, companies will look for ways to align the cost of LTIs with the perceived value — perhaps by using more restricted stock or cash.

## **6. Provide more information about the goals used for the annual and LTI program.**

Companies have long complained that providing detailed information about goals gives their competitors inside information about their business, which has, up until now, been sufficient reason for excluding this information from proxy statements. However, the SEC likely will require disclosure about the performance goals that would produce a payout. Shareholders will be looking for incentive plans with goals that *exceed* Wall Street expectations on growth and earnings.

## **7. Provide perquisites to executives only when they're necessary to influence performance, not because "everyone else is doing it."**

Big severance payments, lavish perks and outsized payments for lackluster performance often occur because compensation committees have felt it necessary to be competitive. Additionally, the committee is told about new perks that other managers are receiving. But as Warren Buffet, CEO of Berkshire Hathaway Inc. and legendary investor, said in his recent letter to shareholders, this line of thinking leads to yesterday's most egregious excess becoming today's baseline. Focusing on performance-based incentives is a better alternative.

## **8. Delve deeper into the personal relationships between board members and executives.**

In order to avoid any appearance of impropriety, companies should examine

FIGURE 1: EXAMPLE TALLY SHEET


	Competitive Data			
	CEO	Company A	Company B	Company C
Salary				
Bonus				
Stock Options — Present Value				
Stock Options — Future Value (5yr, 7%)				
Restricted Stock — Present Value				
Restricted Stock — Future Value (5yr, 7%)				
Performance Shares/Units — Present Value				
Performance Shares/Units — Target Value				
Performance Shares/Units — Max Value				
Qualified Retirement at Age 65				
SERP at Age 65				
Deferred Compensation at Age 65				
From Salary				
From Bonus				
From Interest (% rate)				
Change of Control				
Tax Gross-Up				
Severance Agreement (Multiple of Salary & Bonus)				
Perquisites				
Tax and Financial Advisors				
Clubs				
Cars				
Drivers				
Physicals				
Aircraft				
<b>TOTAL</b>				

the personal relationships between executives and boards. The SEC soon will require extensive information on this subject. Although the board represents the interests of shareholders, some critics charge that in recent years board members have become beholden to the CEO. Serving on a corporate board provides a good level of part-time compensation. Board members have been known to become involved in investment partnerships with CEOs

and may receive donations to their favorite charities and other assorted side deals that create potential conflicts of interest and could compromise their objectivity. The SEC currently requires disclosure of these deals, and companies have begun to weed out potential conflicts. To really address the issue of board-member independence, the company should exclude the CEO from the process of selecting new board members. Companies can get ahead

of the SEC by adopting this policy and disclose the board's process for selecting new directors.

### Preparation is the Key to Success

Many compensation experts expect “how” executives get paid to change more than “how much” they get paid. But the full effect of the regulations likely won't be seen until the first proxy reporting period. Still, by making efforts to increase transparency now, tie compensation to performance, simplify plan designs, analyze board/executive relationships and provide LTI goals to shareholders, companies can stay ahead of the game in terms of both public perception and SEC compliance. 

**Editor's Note:** To stay updated on the SEC proposed rules, visit the Issue Tracker section of the WorldatWork home page, [www.worldatwork.org](http://www.worldatwork.org).

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