Proxy Disclosure 2010: What You Need to Know Now

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Agenda

- Recent SEC guidance regarding proxy disclosure
- Summary of new SEC proxy disclosure rules
- Conducting a comprehensive risk assessment and designing compensation programs with acceptable risk-taking features

Recent SEC Staff Guidance

- CD&A disclosure should be improved
  - Too much detail regarding decision making framework, not enough analysis
  - Explain why the committee made the decisions it made
  - Use plain English
  - Be specific: provide disclosure for each executive as to all elements of compensation
  - Explain changes in amounts paid year over year: why did compensation increase/decrease?
  - Describe how individual decisions fit into overall compensation program
  - Review your CD&A: edit it, rewrite it, include more analysis, focus on explaining decisions made

Recent SEC Staff Guidance (cont'd.)

  - Performance targets
    - Disclose specific targets and actual achievement level against the targets
    - Very difficult to obtain confidential treatment
  - Benchmarking: disclose names of peer group companies, how selected, and where actual awards made fell relative to the benchmark
- Staff has issued significant guidance: "Staff Observations in the Review of Executive Compensation Disclosure" (Fall 2007), staff speeches, Compliance & Disclosure Interpretations and comments made to issuers. Issuers are now expected to "understand our rules and apply them thoroughly."
- Issuers will be asked to amend filings if material comments are made by the Staff, rather than simply enhancing disclosures in future filings

Summary of New SEC Proxy Rules

- Amendments are effective for issuers with fiscal years ending on or after December 20, 2009 and filing proxy statements on or after February 28, 2010
- Rules apply to companies required to provide disclosure under Item 402 of Regulation S-K (Executive Compensation)
- Smaller reporting companies not required to provide the new compensation risk disclosures

Summary of New SEC Proxy Rules

- New Form 8-K requirement to disclose shareholder voting results within four business days:
  - The date of the meeting and whether it was an annual or a special meeting
  - Brief description of each matter and the voting results

Summary of New SEC Proxy Rules

- Disclosure of value of stock and option awards
  - Stock and option awards in the Summary Compensation Table and Director Compensation Table now reported using aggregate grant date fair value
  - Presentation of prior years must be recalculated
  - Equity awards subject to performance conditions must be reported in the SCT and the Director Compensation Table at a value based on the probable outcome of the conditions. A footnote must disclose the value of the award assuming that the highest level of performance conditions is achieved
  - Current requirement to disclose the grant date fair value in the Grants of Plan-Based Awards Table is retained
  - Review calculation of total compensation to determine named executive officers; revised method of reporting equity awards may change the identity of NEOs

Summary of New SEC Proxy Rules

- Disclosure regarding board leadership structure and board's role in risk oversight
  - Disclose the leadership structure of your board
  - Justify that structure: why do you believe this structure is appropriate, given your specific characteristics or circumstances?
  - Must state why you have combined or separated the principal executive officer and board chair positions
    - If combined, must disclose whether you have a lead independent director and that person's specific role in the leadership of your company

Summary of New SEC Proxy Rules

- Disclosure of director diversity policy
  - State whether and how the nominating committee (or the board) considers diversity in identifying director nominees
  - If a diversity policy exists, describe it, along with how the nominating committee or board evaluates the effectiveness of the policy

Summary of New SEC Proxy Rules

- Disclosure of qualifications of directors and director nominees
  - Describe specific experience, qualifications, attributes and skills that led to the conclusion that the person should serve as a director
  - Public company directorships held by each director and nominee during the past five years
  - Disclose for all nominees as well as incumbent directors
- Disclose various bankruptcy-, criminal-, or securities-related proceedings in last 10 years involving directors, director nominees and executive officers
- Update or supplement your director and officer questionnaires to obtain additional information

Summary of New SEC Proxy Rules

- Disclosure of conflicts of interest involving compensation consultants
  - Adds to current requirement to disclose compensation consultant's identity and role in determining the amount and form of executive compensation
  - Focus: who engaged the consultant? What services did the consultant provide?

Has board/comp committee engaged a consultant to advise on amount/form of executive/director compensation (other than (1) consulting on broad-based plans that don't discriminate in favor of executives/directors or (2) providing non-customized information (i.e., surveys) or information based on parameters the consultant did not develop? ("Exec Comp Services")

- **Yes.** Does that consultant also provide additional services to the company?
  - **Yes.** Were the annual fees for the additional services over $120,000?
    - **Yes.** Disclose (1) annual fees paid for (a) determining/recommending amount/form of executive/director comp and (b) additional services (2) whether management recommended or made decision to hire consultant and (3) if board/comp committee approved additional services
    - **No.** No additional disclosure required
  - **No.** No additional disclosure required
- **No.** Has management engaged a comp consultant?
  - **Yes.** Is the consultant providing both Exec Comp Services and additional services?
    - **Yes.** Were annual fees for additional services over $120,000?
      - **Yes.** Disclose fees paid for (a) determining/ recommending amount/form of executive/director comp and (b) additional services
      - **No.** No additional disclosure required
    - **No.** No additional disclosure required
  - **No.** No additional disclosure required

Summary of New SEC Proxy Rules

- Disclosure Regarding Compensation Policies as they Relate to Risk Management
  - Discuss policies and practices in compensating employees (including employees who are not named executive officers) to the extent that risks arising from such policies and practices are "reasonably likely to have a material adverse effect" on the issuer
    - Higher threshold than proposed rule
    - Smaller reporting companies not required to provide this disclosure

Summary of New SEC Proxy Rules

- SEC identified the following compensation policies and practices that may require discussion:
  - Compensation policies and practices at business units:
    - That carry a significant portion of the company's risk profile
    - With compensation structured significantly differently from the rest of the company's business units
    - That are significantly more profitable than other business units
    - Where compensation expense is a significant percentage of the unit's revenues
  - Compensation policies that vary significantly from the overall risk and reward structure of the company (such as policies under which bonuses are awarded upon accomplishment of a task, but the income and risk to the company extend over a significantly longer period of time)

Summary of New SEC Proxy Rules

- Examples of disclosure that may be required:
  - Design philosophy and implementation of compensation policies for employees whose behavior is most affected by incentives in those policies, as such policies relate to/affect risk taking
  - The company's risk assessment or incentive considerations in structuring policies or awarding compensation
  - How compensation policies relate to realization of risks from employees' actions in the short- and long-term (i.e., by requiring claw backs or imposing holding periods)

Summary of New SEC Proxy Rules

- Examples of disclosure that may be required (cont'd):
  - Policies regarding adjustments to compensation policies to address changes in the company's risk profile
  - Material adjustments made to compensation policies as a result of changes in a company's risk profile
  - Monitoring of compensation policies to determine whether risk management objectives are being met

Summary of New SEC Proxy Rules

- If you have disclosure, where should it be located?
- What if you don't have anything to disclose?

The Perceived Role of Pay in the Great Recession

- Certain commentators, shareholders, and governance groups have charged that flawed compensation design was key to the recession
- Criticisms have included:
  - Compensation plans encouraged too much risk-taking and didn't penalize sufficiently for "bad bets"
  - Too much of total pay was delivered annually in cash, with employees bearing no long-term downside risk
  - Clawbacks didn't exist to recover payments if financial results were misstated or inaccurate
  - Equity awards vested over too short of a time period
  - Many incentive plans were based on revenue, not earnings, and paid for sales regardless of profitability
  - In certain industries, compensation plans were not aligned appropriately with the business cycle
- Merited or not, many of the regulations, legislation, and company-initiated changes were spawned from these charges

Executive Pay Interventions Were Trending Up, But…

- In general, involvement by outside parties in executive pay has increased over time:
  - Stock market rule changes added shareholder rights
  - Activist shareholders have assumed a more forceful role in the process
- Government involvement in executive compensation has typically been indirect . . .
  - Tax law limits on executive pay have existed for many years (e.g., IRC §280G, IRC §162(m), IRC § 409A)
  - SEC disclosure requirements were expanded (2007 proxy disclosure rules, 2007 8-K disclosures, 2010 proxy disclosure rules)
  - IRS Form 990 requirements have been expanded
- …Until 2008 and 2009

…Now We Have a Tidal Wave of Legislation and Principles…

- SEC expanded disclosure rules for executive pay
- FDIC proposal to charge higher insurance premiums to banks with "risky" pay practices
- American Recovery and Reinvestment Act
  - Created pay restrictions on government aid recipients
  - Created the Pay Master role
- US Treasury principles
- US House of Representatives legislation (Frank)
- Financial Services Authority (UK) principles
- Financial Stability Board (G20) principles
- Conference Board report
- Australia Prudential Regulation Authority (APRA) principles
- Numerous academic studies, etc.

...With a Range of Views Regarding Appropriate Executive Compensation Program Design

Pay Architecture	TARP	G-20	Federal Reserve	Pay Czar	"Conventional Wisdom"
High cash salary	✓	X	X	X	X
Require a large portion of cash salary to be deferred in shares				✓	
Require a substantial portion of compensation to be incentive-based, increasing based on responsibility	X	✓	✓	✓	✓
Significant incentive compensation tied to short-term performance increases risk-taking			✓		✓
Reduce the rate at which awards increase with higher performance – the hockey stick			✓		✓
Payment of short-term incentive compensation should be delayed in line with the risk horizon	✓	✓	✓	✓	✓

...With a Range of Views Regarding Appropriate Executive Compensation Program Design

Pay Architecture	TARP	G-20	Federal Reserve	Pay Czar	"Conventional Wisdom"
Significant incentive compensation should be paid in equity	✓	✓	✓	✓	✓
Clawback clauses should permit recovery of previously earned compensation	✓	✓	✓		
Incentive compensation pool should be limited based on net revenues		✓			
Guaranteed bonuses	X	X	X	X	X
Large severance and golden parachutes	X	X	X	X	X
Enhanced executive pensions	X			X	
Stock ownership and holding programs					✓

The New Reality Is That The Compensation Design Process Will Explicitly Take "Risk" Into Account

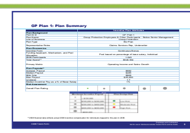
- Acceptable risk taking is a necessary and important part of well-designed compensation programs
- Companies need to take action to:
  - Strengthen the effectiveness of their pay programs by:
    - Defining "risks" based on their unique circumstances
    - Assessing their pay programs to determine what is acceptable and the most appropriate design
  - Disclose, if appropriate, in their proxy filing
    - Enterprise-wide compensation policies and practices relating to risk management practices and risk-taking incentives to the extent that risks arising from these policies and practices are reasonably likely to have a material adverse effect on the company
      - Fortunately, "reasonably likely" is not the reality for most companies
    - Disclosure is not required if this is not applicable to the company; however, companies may decide to state specifically they have reviewed and determined that this is not applicable
- A framework for thinking about different types of "risks" is presented on the next page followed by an approach for conducting a comprehensive risk assessment

There Are Various Categories That Should Be Considered As Companies Think About Their Unique "Risks"

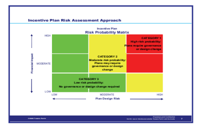
Now we will walk through a risk assessment methodology…

Risk Assessment Methodology Process Overview

1. Conduct Plan Inventory

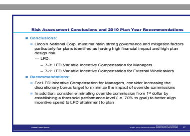


2. Evaluate Plan Design and Governance Risk



3. Assess Potential for Manipulation of Earnings

4. Provide Recommended Action



Incentive Plan:
Operational Risk Assessment & Financial Impact

	Operational Risk		
Financial Impact	**Philosophy/Mix**	**Plan Design**	**Governance and Administration**

• While risk is inherent in all businesses, the key issue is management against appropriate risk standards
• In evaluating the financial impact of risk, consider:
  • Potential monetary impact on business
  • Probability of occurrence
	• Risk inherent in compensation program philosophy and compensation mix
	• Sample key issues/concerns
	  • Does pay philosophy have point of view on risk management?
	  • Is pay mix heavily skewed toward fixed vs. variable pay?
	  • Within variable compensation, is pay appropriately mixed?
		• Risk inherent in compensation program design and mechanics
		• Sample key issues/concerns
		  • Do incentive plans create an opportunity for excessive payouts?
		  • Are incentive performance metrics and plan mechanics aligned with business strategy?
		  • Are there clawback/ holdback mechanisms?
			• Risk inherent in the oversight and administration of plans across the business
			• Sample key issues/concerns:
			  • Does the compensation governance have a clear mandate, ongoing monitoring and oversight?
			  • Do performance targets reflect the appropriate levels of stretch/achievability?
			  • Is there a process for reporting and

Incentive pay by design drives behavior; some behavior creates risk for the enterprise

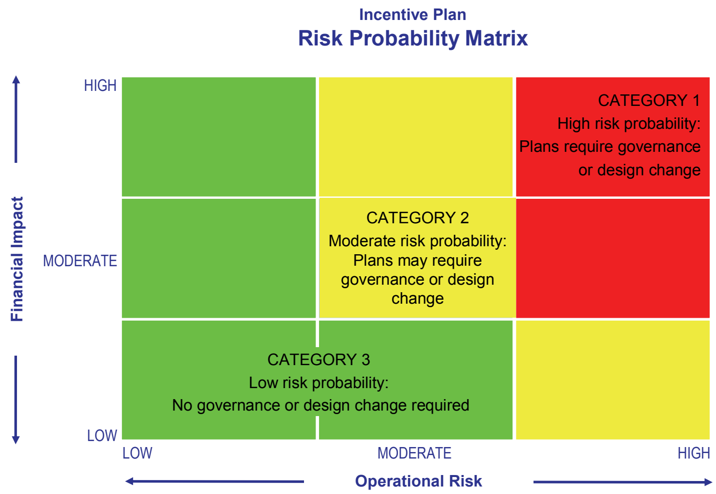
Operational Assessment:
Plan Design Detailed Evaluation Criteria

Evaluation Criteria	Risk Assessment Standards									
Incentive Pay Opportunity										
Maximum Payout	●	<$100,000	●	$100,000 - $200,000	●	$200,000 - $400,000	●	$400,000 - $600,000	●	$600,000+
Incentive Plan Metrics										
Primary Metric	●	Risk-adjusted measure (i.e. RAROC, economic profit) ensures quality results	●	Top-line measure (i.e. volume, revenue)						
Level of Balance (with measure description)	●	Multiple, meaningfully weighted performance measures with at least one that reflects risk	●	All or most incentive based upon a single non-risk adjusted measure						
Corporate Alignment Metric	●	Yes	●	No						
Line of Business/Business Segment Alignment Metric	●	Yes	●	No						
Incentive Pay Determination Methodology										
Upside *(relationship between 90th %ile and 50th %ile incentive pay)*	●	1.0 – 2.5	●	2.5 – 4.0	●	4.0 +				
Cap (Level if capped)	●	Capped (e.g., 200% of Base Salary)	●	Uncapped						
Funding Pool or Budget	●	Yes (i.e. Percentage of earnings)	●	No						
Funding Mechanism	●	Formulaic	●	Discretionary						
Funding Threshold	●	Yes	●	No						
Incentive Form and Calculation Description	●									

Operational Assessment:
Plan Governance Evaluation Criteria

- Independence
  - Is there independent oversight of the plan?
- Design Process
  - Is a clear pay philosophy set relative to market and internal guiding principles?
- Approval
  - Is there formal corporate approval and an approval authority “checklist” by function?
- Exceptions, Disputes and Adjustments
  - Is this process clear, well understood, documented and executed consistently?
- Accurate and Timely Payouts
  - Is data tracking accurate and timely?
  - Is performance communicated on an ongoing basis during the performance period?
- Plan Monitoring and Oversight
  - Is there a “scorecard” for assessing plan performance during the performance period?
  - Are periodic reviews conducted with a cross-functional team to inform future design?

Plan Design And Governance Risk Assessment: Each Plan is Reviewed Consistently and Assigned to One of the Nine Probability Matrix Boxes



In Light Of The Crisis And Public Pressure, Some Companies Are Making Changes To Address The Risk Issue

- Implementation of clawback provisions
  - Allows recoupment of awards under certain conditions
  - Mitigates risk of manipulating short-term results
- Shift from revenues to earnings as an incentive driver
  - Mitigates risk of maximizing sales without profits
- For financial institutions, use of cost of capital/capital adequacy to determine annual incentive pool
  - Ensures that income statement does not take precedence over stability
- Forced deferral of a portion of annual incentive and increased focus on performance over the longer term
  - Part of incentive paid in stock or cash that vests over a multi-year period
  - Greater prevalence of three-year performance plans
  - Subject to forfeiture (bad actors, resignation)
  - Mitigates behavioral risk and myopic focus on short-term results

In Light Of The Crisis and Public Pressure, Some Companies Are Making Changes (cont'd)

- Retention ratios
  - Requires percentage of equity awards to executives be held for a period of time or until retirement/termination
  - Mitigates risk of focusing on ST gain at the expense of LT shareholder value
- Governance changes
  - Increased independent oversight of compensation, both in approving plan design and plan payouts
- Greater use of discretion and judgment
  - Taking into account not just results but how they were achieved; aimed at behavioral risk and compliance risk
- Comprehensive audits of pay and risk across the organization
  - Includes all incentive plans and tests for operational risk and financial impact
- The challenge for companies is to balance the pressures of the current environment with the need to attract, retain, and motivate top talent

Questions & Answers

Thank You

- A copy of the PowerPoint presentation and a multimedia recording will be available on our Web site within 2-3 days: http://www.foley.com/news/event_detail.aspx?eventid=3156

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