COMPENSATION COMMITTEE REPORTS POST-SARBANES-OXLEY: UNIMPROVED DISCLOSURE OF EXECUTIVE COMPENSATION POLICIES AND PRACTICES

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I. INTRODUCTION

In the wake of an avalanche of corporate scandals, a re-energized debate over executive compensation has ensued. Sound bites and headlines demanding "pay for performance" resonate among a scorned investing populace. The passage of the Sarbanes-Oxley Act of 2002[1] ("Sarbanes-Oxley" or the "Act") has brought not just executive compensation, but all of corporate governance, out of classrooms and into living rooms around the country. In the light of these extraordinary events, this Article discusses and analyzes the improvements, if any, companies have made in the disclosure of their executive compensation policies and practices since the passage of Sarbanes-Oxley. Concurrently, this Article

[1] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified at 15 U.S.C. § 7201).

examines the guidance the SEC has provided in the area of compensation committee reports and argues that the SEC guidance is not clear and must be revisited.

Specifically, this Article first discusses the history behind the passage of Sarbanes-Oxley and the advent of the "compensation committee report" through which companies communicate their executive compensation policies and practices. Second, this Article details the compensation committee report's technical requirements. Third, this Article analyzes the guidance (and lack thereof) the SEC has provided with respect to the compensation committee report requirements. Finally, ten widely-held companies' 2002, 2003, and 2004 compensation committee reports are analyzed utilizing the framework provided by the SEC's rules. Systematic non-compliance with the SEC rules is apparent. A "Compensation Committee Report Guide" is appended to this Article in an attempt to provide companies with a roadmap to follow in complying with the compensation committee report requirements.

II. BACKGROUND

A. Sarbanes-Oxley

Myriad corporate scandals leading up to the passage of the Sarbanes-Oxley Act have compelled a thorough examination of the manner in which public corporations in this country govern themselves. When Enron Corporation filed for bankruptcy protection on December 2, 2001, it went from the seventh-largest company in the United States[2] to the company with the largest bankruptcy filing in United States history.[3] The investigations surrounding Enron's financial and legal troubles revealed wide-spread fraud and other forms of corporate malfeasance that led to the

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[2] *See* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1234 (2002).

[3] Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy*, WALL ST. J., Dec. 3, 2001, at A3.

company's collapse,[4] costing thousands of jobs and wiping out billions of dollars in shareholder value.[5] Moreover, it became clear that many of the outside professionals who had been engaged by Enron were helping to perpetrate and to conceal these illegal acts.[6] The public was outraged. In an effort to restore confidence in corporate America,[7] the first draft of Sarbanes-Oxley was referred to the House Committee on Financial Services in February 2002.[8]

Sarbanes-Oxley did not immediately garner overwhelming support, however. Many viewed it as an over-reaching response to a few isolated events.[9] But when

[4] *See* Gordon, *supra* note 2, at 1234 (stating that following the collapse of Enron, there were investigations by, among others, a "special committee" of Enron's board, which found that much of the company's reported profits over the previous four years were the result of accounting manipulations).

[5] STAFF OF SENATE COMM. ON GOV'T AFFAIRS, 107TH CONG., COMMITTEE STAFF INVESTIGATION OF THE FEDERAL ENERGY REGULATORY COMMISSION'S OVERSIGHT OF ENRON 26, at 2, n.75 (2002) (stating that Enron's collapse left thousands unemployed, destroyed billions of dollars of shareholder value and caused crises in U.S. financial and energy markets).

[6] Scott Siamas, *Primary Securities Fraud Liability for Secondary Actors: Revisiting* Central Bank of Denver *in the Wake of Enron, Worldcom, and Arthur Andersen*, 37 U.C. DAVIS L. REV. 895, 897 (2004) (stating that Enron had paid the accounting firm of Arthur Andersen LLP tens to hundreds of millions of dollars a year for services that allegedly facilitated Enron's fraud).

[7] *See* S. REP. NO. 107-146, at 2 (2002) (statement of Senator Leahy) (stating that the Act is intended to guarantee "trust in the financial markets by ensuring that the corporate fraud and greed may be better detected, prevented and prosecuted" and to "ensure that such greed does not succeed").

[8] For a chronology of Sarbanes-Oxley on Capitol Hill, see BILL SUMMARY & STATUS FOR THE 107TH CONGRESS, H.R. 3763, *at* http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HR03763:@@C@s [hereinafter BILL SUMMARY AND STATUS] (last visited Jan. 23, 2005).

[9] Troy A. Paredes, *After the Sarbanes-Oxley Act: The Future of The Mandatory Disclosure System*, 81 WASH. U. L.Q. 229, 231 (2003) (explaining that broad-based support for Sarbanes-Oxley came about only after the "perfect storm" of multiple corporate scandals converged, and that "[i]f the debacle at Enron had been an isolated incident, and could

WorldCom filed for bankruptcy just seven months after Enron and nearly doubled Enron's previously record-setting filing,[10] Sarbanes-Oxley received all the support it needed. Within weeks of the WorldCom news, Congress passed Sarbanes-Oxley by a vote of 423 to 3 in the House and 99 to 0 in the Senate,[11] ushering in a new era for public corporations—an era in which corporate governance can no longer be neglected.[12]

B. Corporate Governance and Executive Compensation

Corporate governance is "the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by the chief executive officer), and (3) the board of directors."[13] The manner in which executives are compensated is an essential element of

have been written off as the work of a few rotten apples at the company, perhaps Congress and the President would have sat tight").

[10] Shawn Young et al., *Debt, Scandal Overwhelm; Operations Set to Continue During a Reorganization*, WALL ST. J., July 22, 2002, at A3 (stating that WorldCom's assets were listed at $107 billion, while Enron's were $63.4 billion).

[11] *See* BILL SUMMARY & STATUS, *supra* note 8. The vote took place on July 25, 2002. Sarbanes-Oxley was signed by President George W. Bush and became Public Law No. 107-204 on July 30, 2003.

[12] As Professor Parades notes,

> [O]nce WorldCom broke in mid-June of 2002, it became clear that the U.S. corporate governance system was suffering from deep systemic flaws that needed to be fixed. As political pressures mounted, and as stock prices continued to plummet, something had to be done. In late July, within weeks of WorldCom breaking, Congress adopted, by a vote of 99 to 0 in the Senate and 423 to 3 in the House, what is proving to be the most important federal corporate governance and securities legislation since the Securities Exchange Act of 1934 . . . .

Paredes, *supra* note 9, at 231 (footnote citation omitted).

[13] ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 1 (2d ed. 2001).

any corporate governance system.[14] A fundamental conflict of interest exists, however, between shareholders and executives with respect to executive compensation. On the one hand, shareholders want executive compensation to be as closely linked to corporate performance as possible. On the other hand, executives want their total potential compensation to be as fixed as possible.[15]

When executive compensation appears excessive in light of corporate performance, the press has been there to help shareholders fan the flames.[16] The New York Stock Exchange board of directors' recent approval of a $187 million pay package for its then-CEO, Richard Grasso, for instance, sparked an avalanche of reporting by the *Wall Street Journal* and other business periodicals, eventually leading to Mr. Grasso's resignation.[17] In an almost equally-publicized case, the shareholders of Walt Disney Corporation brought a derivative action alleging the board of directors "consciously and intentionally disregarded their responsibilities" regarding a $38 million cash and $3 million stock option payout to the company's former president, who spent only fourteen months on the job.[18]

While the passage of Sarbanes-Oxley has just recently thrust corporate governance issues into the spotlight, concerns over excessive executive compensation have been heating up for well over a decade.[19] Complaints of excessive executive compensation have long had political and economic appeal and generate headlines from the financial pages to the comic pages.[20] In fact, public outcry over excessive

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[14] *Id.* at 222.

[15] *Id.* at 224.

[16] *Id.* at 221.

[17] *See, e.g.*, Susanne Craig & Kate Kelly, *Reed Plans NYSE Board Overhaul*, WALL ST. J., Oct. 29, 2003, at A1; Allan Sloan, *A Case of Big Greed at the Big Board; Our Wall Street Editor's Take on Dick Grasso's Payday*, NEWSWEEK, Sep. 22, 2003, at 33-34.

[18] *See In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

[19] MONKS & MINOW, *supra* note 13, at 221.

[20] *Id.*

executive compensation was so widespread in the late 1980's and early 1990's that executive compensation became the subject of magazine cover stories, *Nightline* and *Crossfire* debates, a *60 Minutes* segment, and hearings before the U.S. Congress.[21] *Forbes* even ran a 1991 cover story on executive compensation entitled, "It Just Doesn't Make Sense."[22] It did not take long before the U.S. Securities and Exchange Commission ("SEC")[23] came to outwardly share the public's concern.[24]

C. Advent of Compensation Committee Reports

In July of 1992, the SEC proposed sweeping changes to its executive compensation disclosure rules.[25] As part of this extensive overhaul to its executive compensation disclosure rules, the SEC proposed a new "Board Compensation Committee Report on Executive Compensation" (the "Report"), through which a compensation committee (the "Committee")[26] would disclose its specific rationale for the executive compensation paid, as well as the relationship of the compensation paid to the company's performance. The SEC viewed the Report as a needed addition to the

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[21] *Id.* at 224.

[22] *Id.* at 221.

[23] Unless context specifically indicates otherwise, all references herein to the "SEC" refer to the U.S. Securities and Exchange Commission's Division of Corporation Finance and its staff.

[24] "Faced with the threat of impending Congressional action, the SEC moved, under its own authority, to change the executive compensation disclosure requirements of Regulation S-K. It also made further associated changes to Schedule 14A and Form 10K." Tracy Scott Johnson, *Pay for Performance: Corporate Executive Compensation in the 1990s,* 20 DEL. J. CORP. L. 183, 194-95 (1995) (footnote citations omitted).

[25] Executive Compensation Disclosure, Exchange Act Release No. 33-6940, 57 Fed. Reg. 29,582 (July 2, 1992) (codified at 17 C.F.R. §§ 229, 240) [hereinafter Proposing Release].

[26] Or, in the absence of a compensation committee, the board committee performing equivalent functions or the entire board of directors. 17 C.F.R. § 229.402(k)(3) (2004).

Management's Discussion and Analysis ("MD&A")[27] and believed the Report would "bring shareholders into the compensation committee or board meeting room and permit them to see and understand the specific decisions made through the eyes of the directors."[28]

The Report's requirements, as originally proposed, however, provoked the strongest comments of any of the SEC's July 1992 executive compensation proposals.[29] As the Report's Adopting Release itself noted:

> Some argued that the report was an undue intrusion into the internal affairs of the company and interfered with the operation of the state-law business judgment rule; others argued that the report would interfere unduly with the functioning of the Committee and would deter people from serving as directors. Some questioned the authority of the Commission to require such disclosure, and suggested that the Commission had not previously required, and should not begin to require, disclosure of the bases for board or committee actions . . . . Finally, many raised concerns about the potential for litigation with respect to these reports, particularly in light of the signature requirement.[30]

Accordingly, the Report's requirements, as adopted, attempts to strike a balance between the concerns listed above and providing shareholders with meaningful disclosure.[31]

In addressing commentators' competitive harm concerns, the SEC made it clear that companies would not be required to disclose confidential, commercial, or business

[27] *See* 17 C.F.R. 229.303 (2004).

[28] Proposing Release, *supra* note 25, at 29,593-34.

[29] Executive Compensation Disclosure, Exchange Act Release No. 33-6962, 57 Fed. Reg. 48,126, 48,138 (Oct. 21, 1992) (codified at 17 C.F.R. §§ 228, 229, 240, 249) [hereinafter Adopting Release].

[30] *Id.*

[31] Emanuel D. Strauss, *The Honeymoon is Over for Compensation Committee Reports,* 7 INSIGHTS, No. 10, 2 (1993).

information.[32] Moreover, the Report, as adopted, only requires specific disclosure with respect to the CEO rather than all the named executives, as was proposed.[33] As to liability concerns, the SEC also stated that "the proper response [for shareholders dissatisfied with the decisions reflected in the Report] is the ballot, not resort [sic] to the courts to challenge the disclosure."[34] Consequently, Reports will not be deemed to be soliciting material or to be "filed" under Section 18; they are given the same status as a company's glossy annual report.[35] Additionally, the Reports are only required to be included in a proxy or information statement relating to an annual meeting of security holders (or special meeting or written consents in lieu of such meeting) at which directors are to be elected.[36]

In response to commentators' other concerns, the SEC stated that the Report did not impose new fiduciary standards on directors.[37] The SEC responded further that the Report was not inconsistent with business judgment standards.[38] With respect to the concern over providing a basis for board action, the SEC pointed to "going-private"

[32] Adopting Release, *supra* note 29, at 48,138; 17 C.F.R. § 229.402(k)(2) (2004).

[33] Adopting Release, *supra* note 29, at 48,138.

[34] *Id.* Dissatisfied shareholders can also voice their disapproval through selling their securities.

[35] *See* Item 402 of Regulation S-K, which states that:

> [t]he information required by paragraphs (k) and (l) of this item shall not be deemed to be "soliciting material" or to be "filed" with the Commission or subject to Regulations 14A or 14C . . . except to the extent that the registrant specifically requests that such information be treated as soliciting material or specifically incorporates it by reference into a filing under the Securities Act or the Exchange Act.

17 C.F.R. § 229.402(a)(9) (2004).

[36] Adopting Release, *supra* note 29, at 48,128; *see also* 17 C.F.R. § 229.402(a)(8) (2004).

[37] Adopting Release, *supra* note 29, at 48,138.

[38] *Id.*

and "roll-up transactions" for precedent.[39] Consequently, with a few other minor adjustments,[40] the SEC adopted the Report in its final form on October 16, 1992.[41]

D. Section 162(m)

On a related front, Congress amended Internal Revenue Code Section 162(m) in August 1993 in an effort to curb excessive executive salaries.[42] In contemplating the amendment, the House Committee on Ways and Means reported the following:

> Recently the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited to $1 million per year.[43]

Although Congress' stated intent was to reduce executive compensation, "the explosion of option grants is evidence that the measure backfired (or was never intended to work). A more charitable reading is that Section 162(m) was supposed to promote options (as well as other "performance

[39] *Id.*

[40] The SEC also changed a signature requirement to allow for names to appear instead of signatures. Also, "if the board modified or rejected in any material way" any Committee action, the Report must be "made over" the names of all members of the board and include an explanation of the board's actions. *See* Emanuel D. Strauss, *The Compensation Committee Report on Executive Compensation,* 6 INSIGHTS No. 12, 11 (1992). [hereinafter *Insights Compensation Committee Reports*].

[41] *See* Adopting Release, *supra* note 29, at 48,159.

[42] SECTION 13211: THE DISALLOWANCE OF DEDUCTION FOR CERTAIN EMPLOYEE REMUNERATION IN EXCESS OF $1,000,000 OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993, PUB. L. NO. 103-66, 107 STAT. 312 (1993).

[43] COMMITTEE ON WAYS AND MEANS: REVENUES REPORT TO ACCOMPANY RECOMMENDATIONS FROM THE COMMITTEE ON WAYS AND MEANS, H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877.

compensation," such as bonuses based on accounting earnings)."[44]

As a further unintended consequence, however, executives' manipulating corporate performance to maximize their own personal wealth became a corporate malfeasance hallmark:

> [W]hether driven by greed or envy—or perhaps both—it is clear now that an increasingly lavish—crazy—stôck-option compensation system incentivized corporate executives to do whatever—and I mean whatever—had to be done to meet earnings expectations, so that they could achieve corporate earnings targets to trigger their performance bonuses and boost the stock price so that their stock options could be exercised and they could sell stock at high prices.[45]

As amended, Section 162(m) generally prohibits publicly held corporations from deducting compensation exceeding $1 million paid to their CEOs or the next four highest-compensated officers unless the compensation is performance-based.[46] Three months after Congress amended Section 162(m), the SEC began to require companies to address in their Policy Disclosure "the registrant's policy with respect to qualifying compensation paid to its executive officers for deductibility under Section 162(m) of the Internal Revenue Code."[47]

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[44] David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 468 (2000).

[45] William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 STAN. J. L. BUS. & FIN. 69, 96 (2002).

[46] *See* 26 U.S.C. § 162(m) (2000).

[47] Executive Compensation Disclosure; Securityholder Lists & Mailing Requests, Exchange Act Release No. 33-7032, 58 Fed. Reg. 63,010, at 63,011 (NOV. 29, 1993) (codified at 17 C.F.R. §§ 228, 229, 240 (2004)).

E. Short-Lived Improvement

On August 6, 1993, the SEC provided guidance (the "Guidance") on what it expected from companies with respect to their Reports.[48] By that time, the SEC had experienced one full proxy season with the Reports as a requirement. The SEC reviewed approximately 1,000 proxy statements to form the basis for its conclusions[49] and made it clear that subsequent Reports must contain more specificity with respect to disclosing executive compensation decisions.[50] Specifically, the SEC found that some Reports "could only be characterized as perfunctory"[51] and that the "principal recurring problem was a lack of specificity."[52] To illustrate these concerns and to assist companies with compliance, the SEC provided a number of examples of the type of disclosures they deemed acceptable. These examples related to "Format," "Specificity," "Size of Pay Packages," and "Criteria for Awards."[53]

The 1994 and 1995 proxy seasons showed marked improvement in the Reports as companies responded to the Guidance.[54] Unfortunately, companies' compliance with the "spirit"[55] of the Reports was generally short-lived:

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[48] Executive Compensation Disclosure; Securityholder List & Mailing Requests, Exchange Act Release No. 33-7009, 58 Fed. Reg. 42,882 (Aug. 12, 1993) (codified at 17 C.F.R. §§ 228, 229, 240 (2004)) [hereinafter Guidance].

[49] *Id.* at 42,882.

[50] *Id.* at 42,887.

[51] *Id.*

[52] *Id.* at 42,888.

[53] *Id.* at 42,882.

[54] Scott P. Spector, *The Compensation Committee Report, in* A PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULES 4-3 (Amy L. Goodman & John F. Olson eds., 3d ed. 2002) [hereinafter GUIDE TO COMPENSATION COMMITTEE REPORTS] (2004 edition omits cited material).

[55] Guidance, *supra* note 48, at 42,887 (noting that some Committees "met the letter and spirit of the requirement, and took advantage of the report to explain fully to shareholders their policies and to provide a clear, concise discussion of how these policies related to recent corporate

> The trend in 1994 and 1995 to prepare thoughtful, creative and interesting compensation committee reports appears to have been interrupted. In fact, it is fair to say that the concern the Commission had in 1993, that certain reports in 1993 were perfunctory, seems to have come to pass. It is not that each of the included [2000 and 2001] compensation committee reports is the same as all the others, rather they are not very useful in indicating how the issuer views compensation on a year-to-year basis. . . . [It] appears that issuers were unwilling to explain how compensation philosophy has changed from year-to-year or how the compensation committee looks at compensation from a broad perspective.[56]

Moreover, the SEC's Director of the Division of Corporation Finance observed as recently as October of 2004 that "[m]uch [of the] disclosure we see in the compensation committee report is just boilerplate and is not very informative. This is the case even though the instructions to the relevant item specifically state that boilerplate should be avoided."[57]

As will be seen in Part IV of this Article, however, the SEC has not provided a clear roadmap for companies to follow.

III. REPORT REQUIREMENTS

A. Item 402(k)

The Report requirements are codified in Item 402(k) of SEC Regulation S-K.[58] Item 402(k) is not lengthy; it consists only of the following three requirements:

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performance and resulted in the executive compensation reported for the prior year").

[56] GUIDE TO COMPENSATION COMMITTEE REPORTS, *supra* note 54, at 4-3 to 4-4.

[57] Alan L. Beller, *Speech by SEC Staff: Remarks Before Conference on the NASPP, The Corporate Counsel and the Corporate Executive*, Oct. 20, 2004, *available at* http://www.sec.gov/news/speech/ spch102004alb.htm.

[58] *See* 17 C.F.R. § 229.402(k) (2004).

[1] Disclosure of the compensation committee's compensation policies applicable to the registrant's executive officers (including the named executive officers), including the specific relationship of corporate performance to executive compensation, is required with respect to compensation reported for the last completed fiscal year.

[2] Discussion is required of the compensation committee's bases for the CEO's compensation reported for the last completed fiscal year, including the factors and criteria upon which the CEO's compensation was based. The committee shall include a specific discussion of the relationship of the registrant's performance to the CEO's compensation for the last completed fiscal year, describing each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based.

[3] The required disclosure shall be made over the name of each member of the registrant's compensation committee (or, in the absence of a compensation committee, the board committee performing equivalent functions or the entire board of directors). If the board of directors modified or rejected in any material way any action or recommendation by such committee with respect to such decisions in the last completed fiscal year, the disclosure must so indicate and explain the reasons for the board's actions, and be made over the names of all members of the board.

B. Policy Disclosure

Item 402(k)(1) can be considered in two prongs. The first prong is prospective: it compels the Committee to disclose its compensation policies relating to all of the company's executive officers.[59] The second and more specific prong is

[59] The term "Executive Officers" is not defined in the Proposing Release, Adopting Release, or Guidance. As proposed, the rules would

retrospective: it requires the Committee to discuss how its policies relate executive compensation to corporate performance for the last completed fiscal year.[60]

This first prong is rather general and allows the Committee an opportunity to communicate fully its executive compensation policies to the shareholders. Policy Disclosure has been the one area of the Reports that has consistently provided shareholders with quality disclosure.

> Policy Disclosure, from 1993 through the 2001 proxy season, has generally consisted of: (1) general goals of compensation (e.g., retention of key executives); and (2) different categories of compensation paid or awarded (e.g., base salary, bonus, long-term-compensation, etc.). As in past years, Policy Disclosure during the 2000/2001 proxy season has remained one of the stronger aspects of the reports with respect to the executive group and the CEO. . . . Although compensation reports have steadily declined in providing meaningful information to stockholders, the reports have continued to provide quality [P]olicy [D]isclosure.[61]

One of the reasons that the Policy Disclosure has been consistently better than other sections of the Report is that companies may find it easier discussing their policies on executive compensation than disclosing how those policies are actually applied on an annual basis.[62] The quality of

have required an individualized discussion of the CEO plus each of the Company's other four most highly compensated executive officers. Proposing Release, *supra* note 25, at 29,593. In response to commentators' concerns, the rules, as adopted, only require a discussion of the extent to which *all* executives' compensation, *in the aggregate*, is performance-related. Adopting Release, *supra* note 29, at 48,138. The SEC did not discuss whether it considered requiring a discussion of the extent to which the four most highly compensated executive officers' compensation, *in the aggregate*, was performance related.

[60] *See* discussion *infra* Part III.C.

[61] GUIDE TO COMPENSATION COMMITTEE REPORTS, *supra* note 54, at 4-18.

[62] *Id.*

Policy Disclosure may also be attributed to institutional investors' activism, including discussions between management and institutional investors when shareholder approval of new executive compensation plans is being solicited.[63]

C. Performance Disclosure

1. Executive Officers

Item 402(k)(1)'s second prong is more pointed. It requires a retrospective discussion of the "specific relationship of corporate performance to executive compensation for the last fiscal year." The SEC has stated that the Committee should indicate the extent to which compensation, in the aggregate (as opposed to an executive-by-executive basis), is performance-related.[64] As with Policy Disclosure, the Committee should also disclose which performance measures the Committee considered (e.g., sales earnings, return on assets, return on equity, or market share).[65] Note that the rules focus on a discussion of the company's performance; a discussion of the executives' performance is not specifically required.

2. The CEO

As with the other executive officers, the Committee must include a specific, retrospective discussion of the relationship of the company's performance to the CEO's compensation for the last fiscal year.[66]

CEO Performance Disclosure goes beyond Executive Officer Performance Disclosure to additionally require the Committee to describe "each measure of the registrant's

[63] *Id.*

[64] Adopting Release, *supra* note 29, at 48,138.

[65] *Id.* This requirement elicits disclosure that overlaps with the Policy Disclosure, but its specific performance measures go beyond the Policy Disclosure. *Insights Compensation Committee Reports*, *supra* note 40, at 14.

[66] 17 C.F.R. § 229.402(k)(2) (2004).

performance, whether qualitative or quantitative, on which the CEO's compensation was based."[67] The Committee must also discuss other factors and criteria, like the CEO's individual achievements if such accomplishments served as bases for the Committee's award.

D. Other CEO Factors and Criteria

Item 402(k)(2) compels disclosure of the Committee's bases for the CEO compensation from the last year, including the "factors and criteria" upon which the CEO's compensation was based.

As distinguished from CEO Performance Disclosure, the "bases" and "factors and criteria" elements of Item 402(k)(2) require a Committee to disclose all the reasons for its decision, not just those factors relating to the company's performance. This gives a Committee the opportunity to discuss the CEO's personal attributes and individual achievements over the past year that are not necessarily reflected in the company's financial statements.[68]

Many companies, however, do not disclose factors and criteria beyond those that are company-specific.[69] The reader of the Report is left to assume the Committee based the CEO's compensation wholly on the measures of company performance. To the extent this is the case, Committees should disclose as much.[70] That is, a Committee should disclose whether its CEO compensation decision is entirely a function of corporate measures.[71] If a Committees decision

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[67] *Id.*

[68] Unlike Executive Performance Disclosure, CEO Performance Disclosure requires disclosure of the Committee's "bases" for its compensation decision. The Committee's bases may very well encompass more than corporate performance measures. *Id.*

[69] *See, e.g.*, Guidance, *supra* note 48, at 42,888. *See also* discussion *infra* Part V.

[70] Guidance, *supra* note 48, at 42,889.

[71] The SEC rules do not require a Committee to discuss in the Report the extent to which corporate performance exceeded market or peer performance. However, this information is contained in the "performance

has been influenced by other "factors and criteria," such as the CEO's personal contributions to corporate performance, the Committee must discuss those other "factors and criteria."[72] Unfortunately, it is not clear from many Reports whether companies distinguish between CEO Performance Disclosure and Other CEO Factors and Criteria.[73]

E. Exclusions

1. Confidential Information

The rules permit Committees the following exclusion:

> Registrants are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the committee (or board), or any factors or criteria involving confidential commercial or business information, the disclosure of which would have an adverse effect on the registrant.[74]

Companies should be wary of relying too heavily on this exclusion, however, because the SEC might require them to justify their non-disclosure.

The instruction that permits reports to omit identifying those factors or criteria involving confidential commercial or business information does not excuse general non-disclosure of the factors or criteria on which compensation was based, citing only unspecified performance or strategic goals. Such reports were uninformative. In the future, where a report fails to disclose the criteria and factors (as distinguished from target levels) used, registrants will be asked to justify

graph" section of the proxy report. Adopting Release, *supra* note 29, at 48,157-58.

[72] It seems this discussion should always be necessary. Otherwise, the Committee implies that the CEO's compensation was based entirely on the CEO title, and without regard to the CEO's personal contributions to corporate performance.

[73] *See* discussion *infra* Parts IV & V.

[74] 17 C.F.R. § 229.402(k), Instruction 2 (2004).

the non-disclosure and to include in the report disclosure that the Committee believes identifying the factors or criteria would adversely affect the company.[75]

2. Liability

In response to concerns many commentators had over potential litigation, the SEC stated that "[i]f shareholders are not satisfied with the decisions reflected in the report, the proper response is the ballot, not resort to the courts to challenge the disclosure."[76] To that end, the Reports are not deemed by the SEC to be "soliciting material" or to be "filed" with the SEC nor will they be subject to Regulations 14A (solicitation of proxies) and 14C (distribution of information) or to the liabilities of Section 18 (misleading statements) of the Exchange Act, except to the extent the company specifically requests it be treated as such.[77]

Moreover, because the Reports are not "filed" with the SEC, they are not incorporated by reference into a company's registration statements filed pursuant to the Securities Act of 1933 (the "Securities Act"). Consequently, the Reports are not subject to liability under the Securities Act.[78]

However, the SEC's Director of the Division of Corporation Finance recently suggested that the SEC may

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[75] Guidance, *supra* note 48, at 42,889. The SEC again refers to "criteria and factors" in a non-specific fashion.

[76] Adopting Release, *supra* note 29, at 48,138.

[77] *Id.* at 48,138-39. Notwithstanding these liability limitations, a federal district court, in connection with a claim made under Exchange Act Section 14(a) and Rule 14a-9, recently examined whether a public company had adequately disclosed its 162(m) Policy in its in proxy statement. In doing so, the court only made reference to the SEC Release that requires Committees to disclose their 162(m) Policy, without cross-referencing the Report's Adopting Release. *See* Vides v. Amelio, 265 F. Supp. 2d 273, 281 (S.D.N.Y. 2003).

[78] *See* David B.H. Martin & Graham Robinson, *Securities Disclosure, To Be or Not to Be "Filed"*, 17 No. 9 INSIGHTS 4 (2003) (stating that the SEC's clear articulation of the Reports' "not filed" status removes the Reports from potential Securities Act liability).

shift its treatment of the Reports with respect to liability issues.

> I should note in this area that, at the request of companies and their advisers and in an extra step to encourage transparency in these reports, the Commission provided that compensation committee reports are not "filed" under the Securities Exchange Act of 1934 and are not incorporated by reference in registration statements. I would submit that companies and their advisers have not reciprocated with more transparent disclosure. We may consider whether this special treatment should continue or how we can achieve disclosure that merits the treatment.[79]

Favorable treatment notwithstanding, the SEC has never attempted to limit liability associated with the Report from Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder (manipulative and deceptive devices).[80] Accordingly, a company's Report may become the subject of a shareholder suit or SEC enforcement action brought under Exchange Act Section 10(b) and Rule 10(b)(5). Any such action would require a showing of scienter, however, making liability much more difficult to establish than would otherwise be the case but for the Reports' "not filed" status.[81]

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[79] *See* Beller, *supra* note 57. Mr. Beller believes, however, that the Guidance is "still sound, and companies and compensation committees would benefit from reconsidering it:" *Id.*

[80] GUIDE TO COMPENSATION COMMITTEE REPORTS, *supra* note 54, at 4-12. Legal research reveals no cases in this area.

[81] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) (mere negligent behavior is not enough to establish the scienter requirement embodied in Section 10(b)'s operative language); *See also* Aaron v. SEC, 446 U.S. 680, 691 (1980) (scienter requirement extended to SEC enforcement actions brought under Section 10(b) and Rule 10(b)(5)).

F. The Compensation Committee

1. Who is Responsible?

Item 402(k)(3) requires the Report be recommended by the company's compensation committee or other board committee performing equivalent functions, in the absence of any such committee, or the entire board of directors (in any case, the "Committee").

Item 402(k)(3) further requires that the Report "be made over the name of each member" of the Committee. The SEC has stated this requires individual listings of the Committee member names in block format following the text of the report.[82] As proposed, the rules would have required Committee members to actually sign the Report.[83]

2. Listing Standards

On November 4, 2003, the SEC approved new corporate governance listing standards for the New York Stock Exchange ("NYSE") and NASD.[84] Companies listed on the NYSE or quoted on NASDAQ were required to begin complying with these new listing standards on the earlier of their first annual meeting after January 15, 2004, or October 31, 2004.[85]

Under the NYSE rule, companies must have a compensation committee composed entirely of independent directors.[86] Acting on its own, or together with the other

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[82] Guidance, *supra* note 48, at 42,887.

[83] Proposing Release, *supra* note 25, at 29,593. However, the purpose of the signature requirement—accountability for the Report—is still fulfilled. Logistical issues with obtaining and reproducing manual signatures have been obviated. Some Committee members may also feel less of a liability risk, even though the absence of their signature is inconsequential. Adopting Release, *supra* note 29, at 48,139.

[84] NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 34-48745 (Nov. 4, 2003), 68 Fed. Reg. 64,154 (Nov. 12, 2003).

[85] *Id.* at 64,179.

[86] *Id.* at 64,177.

independent directors, the compensation committee determines and approves the CEO's compensation and makes recommendations to the board with respect to non-CEO compensation.[87] Moreover, the NYSE requires compensation committees to establish a charter, which sets forth, inter alia, the committee's purpose and responsibilities, and an annual performance evaluation of the compensation committee.[88]

NASD, meanwhile, requires the compensation of the CEO and other executive officers of an issuer "be determined or recommended to the board for determination either by a majority of independent directors or by a compensation committee comprised solely of independent directors."[89] The CEO may not be present during voting or deliberations on the CEO's compensation.[90] NASD does not require compensation committees to establish a charter.

G. Section 162(m) Policy

On November 29, 1993, the SEC began to require companies to address in their Policy Disclosure "the registrant's policy with respect to qualifying compensation

[87] *Id.*

[88] *Id.* at 64,157. The listing standards do not require the charter to be incorporated into a company's by-laws or articles of incorporation.

[89] *Id.* at 64,177.

[90] *Id.* However, the rules also note that:

> [t]he Nasdaq proposal permits one director who is not independent and is not a current officer or employee or Family Member of such person to be appointed to the committee for a limited term if the board, under exceptional and limited circumstances, determines that such individual's membership is required and discloses the nature of the relationship and the reasons for the determination.

Id.

paid to its executive officers for deductibility under Section 162(m) of the Internal Revenue Code."[91]

I.R.C. Section 162(m) allows public companies to deduct executive compensation[92] expenses in excess of $1,000,000 to the extent the compensation over $1,000,000 is awarded on a performance basis.[93] Performance-based compensation must be paid pursuant to a shareholder-approved plan[94] and awarded by a committee consisting of two or more outside directors[95] that determines performance goals[96] and certifies that performance goals were in fact satisfied.[97] An "outside director" is defined by the IRS as a director who:

> is not a current employee of the company (or certain related entities);
>
> is not a former employee of the company (or certain related entities which are still in the affiliated group) receiving compensation for prior services (other than benefits under a tax-qualified pension plan) during the taxable year;
>
> was never an officer of the company (or certain related entities that are still in the affiliated group); and
>
> is not currently receiving remuneration (which includes payments in exchange for goods or services) from the company, either directly or indirectly, in any capacity other than as a director.[98]

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[91] Executive Compensation Disclosure; Securityholder Lists & Mailing Requests, Exchange Act Release No. 33-7032, 58 Fed. Reg. 63,010 (Nov. 29, 1993) (to be codified at 17 C.F.R. §§ 228, 229, 240).

[92] The deduction only applies to the CEO and the company's four other highest paid executive officers during the taxable year. 26 U.S.C. § 162(m)(3)(A) (2000).

[93] 26 U.S.C. § 162(m) (2000).

[94] 26 U.S.C. § 162(m)(4)(C)(ii) (2000).

[95] 26 U.S.C. § 162(m)(4)(C)(i) (2000).

[96] *Id.*

[97] 26 U.S.C. § 162(m)(4)(C)(iii) (2000).

[98] *See* 26 C.F.R. § 1.162-27(e)(3) (2002).

While binding on companies, the requirement that Committees disclose their IRC Section 162(m) policies in the Reports has not been incorporated into the text of Item 402(k).[99]

H. Organization

The organization and formatting of the Report is largely left to the Committees' discretion. The only requirements are as follows:

- the Report must be separately captioned;[100] and
- the Report must appear over the names of the Committee members.[101]

If different board committees determine different components of executive compensation arrangements, companies have the option of presenting either i) a joint report of the names of the members of each committee responsible, separately listed by committee, or ii) providing separate reports for each committee.[102]

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[99] "The suggestion that deductibility under I.R.C. § 162(m) be addressed in the compensation committee report was not included in the rule amendments and thus is only an 'interpretation.'" *See* Klaus Eppler and Lauren Boglivi, Corporate Law and Practice Course Handbook Series, *The Compensation, Committee Report, Performance Graph and Certain Other Executive Compensation Disclosure Requirements* 102 (Practicing Law Institute, Jan.-Feb. 1995).

[100] Guidance, *supra* note 48, at 42,887. This requirement does not appear in Item 402(k).

[101] *Id.*; *see also* 17 C.F.R. § 229.402(k)(3) (2004).

[102] Guidance, *supra* note 48, at 42,887. *But see supra* Part III.F.2 (discussing NYSE and NASDAQ listing standards regarding compensation committee composition and duties).

IV. SEC GUIDANCE (AND LACK THEREOF)

A. Specificity in CEO Performance Disclosure

During the 1993 proxy season, the SEC reviewed approximately 1000 Reports and found that the Reports' "principal recurring problem was a lack of specificity."[103] Companies responded with greater specificity in their Reports over the next couple of years.[104] Unfortunately, Reports after 1996 have become more general and full of boilerplate.[105] In fact, over a decade later, the SEC is expressing the very same concerns today:

> Much disclosure we see in the compensation committee report is just boilerplate and is not very informative. This is the case even though the instructions to the relevant item specifically state that boilerplate should be avoided.[106]

The SEC's 1993 review found the specificity problem to be especially prevalent in the area of CEO compensation. "The lack of specificity was a particular problem with respect to CEO compensation for which more individualized disclosure is required by the rule."[107] To help companies provide more specificity, particularly with respect to CEO disclosure, the SEC issued its Guidance on August 6, 1993.[108]

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[103] Guidance, *supra* note 48, at 42,888.

[104] GUIDE TO COMPENSATION COMMITTEE REPORTS, *supra* note 54, at 4-14.

[105] *Id.*

[106] *See* Beller, *supra* note 57. Mr. Beller believes, however, that the Guidance is "still sound, and companies and compensation committees would benefit from reconsidering it." *Id.*

[107] Guidance, *supra* note 48, at 42,888.

[108] *Id.* Legal research reveals no SEC enforcement actions to date. However, General Electric Company ("GE") recently settled an SEC enforcement action where the SEC found that GE had failed to adequately describe the terms and conditions of the retirement compensation package that GE had extended to its former CEO, John F. Welch, Jr., as required by Item 402(h)(2) of Regulation S-K. Item 402(h)(2) relates to post-employment arrangements with named executive officers and is not part of the Report's requirements. *See* General Electric Co., 2004 LEXIS 2174

In the Guidance, the SEC provided the following Report excerpt as an example of a "lack of specificity":

> Mr. John Doe, President of the Corporation . . . has had the same salary since February 1989. Currently, there is no formal incentive plan for Mr. Doe. On January 14, 1993, the Board of Directors of the Corporation approved a bonus equivalent to 25% of salary for Mr. Doe, after having considered its evaluation of the Corporation's performance for 1992 and improved financial results.[109]

Although there is no formal incentive plan for Mr. Doe, the Committee has awarded Mr. Doe with a 25% bonus. The Committee states that it did so after having evaluating the Corporation's "performance" and its "improved financial results." What "performance" is the Committee talking about? It does not tell us. To which financial results is the Committee referring? It is impossible to tell. This disclosure clearly falls short of describing "each measure" of the company's performance upon which Mr. Doe's compensation was based and makes a half-hearted attempt at tying Mr. Doe's compensation to the company's performance.

By way of contrast, the SEC provided CEO Performance Disclosures from three other Reports, which the SEC believes "provide shareholders with a more informative discussion."[110] While these examples are certainly better than the one above, none seems to completely fulfill the requirements of the Report. Those examples are as follows:

(Sept. 23, 2004). In 1997, the SEC settled a similar action under similar facts against W.R. Grace & Co. *See* W.R. Grace & Co., 53 S.E.C. 225 (Sept. 30, 1997).

[109] Although Mr. Doe is referred to as the "President," context suggests that he is the "CEO" for purposes of the SEC rules. Disclosure regarding individual executives is specifically not required by the rules. Guidance, *supra* note 48, at 42,888.

[110] Guidance, *supra* note 48 at 42,888. Examples cited came from actual Reports. *Id.* at 42,887.

Company A:

> Mr. Smith would receive an incentive payment of 80% of base salary at target performance and an incentive payment of 120% of base if the Corporation's return [reached the maximum]. For 1992, the Corporation's return on average shareholders' equity equaled 13%.

Company A, as opposed to the first example, specifies a measure of corporate performance—return on equity reaching a specified amount—upon which the CEO's compensation was based. Item 402(k)(2), however, requires a description of "each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based." Company A mentions only one measure—a quantitative measure: return on equity. If return on equity is the one and only measure of corporate performance bearing on Mr. Smith's compensation, Company A should disclose as much. No Other CEO Factors and Criteria are discussed as bases for the Committee's decision.

At first blush, the relationship between the company's performance and Mr. Smith's pay seems to be addressed. The company established a bonus range, which corresponds to a certain a maximum level of the company's performance. Return on equity was 13%; presumably, Mr. Smith received some bonus (between 80% and 120% of his base salary) for that amount of shareholder return. Unfortunately, that information was either not excerpted by the SEC or was not included by Company A. In either case, the example provided does not indicate whether, or to what extent, Company A tied together its discussion of the relationship between corporate performance and Mr. Smith's pay.

Corporate performance can be gleaned from the MD&A and from a review of the company's financial statements. The dollar amounts of a CEO's compensation can be found in several other places in a company's proxy statement. CEO Performance Disclosure only adds value to the extent that the relationship between those two sets of data is explored.

If merely stating that the one is a function of the other suffices, then the requirement is illusory.[111]

> Company B:
>
> Under the employment agreement, Mr. Brown is eligible for an annual bonus in an amount to be determined by the Compensation Committee based upon such factors as the Compensation Committee deems appropriate.[112] In 1992, the Company successfully implemented its turnaround strategy, including a return to profitability, a significant increase in cash flow from operations, and a substantial decrease in total debt. This was accomplished during a period of difficult industry and global economic conditions, and led to a substantial increase in stockholder value. Based on these results, the Compensation Committee awarded Mr. Brown a bonus in the amount of $1,080,000 for 1992.

Unlike Company A, Company B indicates a number of corporate performance measures upon which Mr. Brown's compensation was based. Those factors relate to Company B's successful "turnaround strategy" (e.g., profitability, cash flow, and debt reduction). No Other CEO Factors and Criteria were mentioned.

Company B attempts to address the relationship between company performance and Mr. Brown's compensation by indicating that Mr. Brown's bonus was based on the corporate-performance measures. However, no attempt is made to communicate the degree to which Company B's turnaround and Mr. Brown's $1,080,000 bonus are related.

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[111] Item 402k(2) requires not only disclosure of "each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based"; it also requires a "specific discussion of the relationship of the registrant's performance to the CEO's compensation for the last completed fiscal year."

[112] The Committee goes on to discuss which factors it deemed appropriate in 1992. It would be insufficient, however, for the Committee simply to state that it deemed the factors upon which it relied to be appropriate without going on to identify the "specific factors or criteria used." Guidance, *supra* note 48, at 42,889.

That is, there is no discussion of the proportionality of Mr. Brown's bonus to the turnaround or perhaps even how $1,080,000 compares to previous bonuses in light of corporate performance for that year.

As it is, Company B's CEO Performance Disclosure states two facts: 1) the company did well, and 2) Mr. Brown was given a million dollar bonus. That Company B simply states that the latter is a function of the former, without more, is not very useful. The pivotal question, and crux of this requirement, is: How are the two related? Allowing that question to go unanswered is to defeat the primary purpose of the Reports, which is to "bring shareholders into the compensation committee or board meeting room and permit them to see and understand the specific decisions made through the eyes of the directors."[113]

> Company C:
>
> The Company's 1992 performance consistently exceeded aggressive targets. Despite the sluggish economy, the Company beat 1991's operating and financial results before the 1991 special charge. In addition, the Company out-performed both the S&P 500 and its peer group index (defined with the performance graph) in dividend and shareholder value growth. The Company earned $728 million in 1992, compared to $64 million in 1991. . . . During 1992, the Company's stock price grew 13% while the average stock price of its peers rose 10% and the S&P stock index increased 4.5%.
>
> The 1992 performance continues a series of strong years. Since 1989, the Company's earnings per share have grown from $2.81 to $3.57, an average annualized increase of 8%, while the S&P 500's earnings . . . declined 5% per year. . . . In addition to leading the Company to outstanding financial achievements, Mr. Roe has established a strong record in the areas of customer service, technology use and innovation, quality, governmental relations

[113] Proposing Release, *supra* note 25, at 29,593-34.

> and management efficiency, and has built a strong management team and aggressively pursued new areas for growth.[114]

Company C lists a number of corporate-performance measure upon which Mr. Roe's compensation was based (e.g., stock price and earnings per share). Company C also disclosed numerous Other CEO Factors and Criteria, which served as bases for its decision (e.g., Mr. Roe's record of customer service, innovation, and quality). Moreover, unlike Company B, Company C quantified its corporate performance measures and compared its performance to that of its peer group. Like Companies A and B, however, Company C does not answer the all-important question of the manner and extent to which corporate performance is related to CEO compensation, as required by the SEC's rules.[115]

B. Criteria for Awards

The SEC issued a number of comments "aimed at achieving greater specificity in the discussion of policies, particularly identification of the performance criteria or other bases for compensation used, as well as more precision in the discussion of how the size of various components of the compensation package were determined."[116]

Under the SEC's rules, "criteria" and "bases" are only required in a discussion regarding the CEO.[117] "Criteria" and "bases" are not required as part of the Committee's discussion of its Policy Disclosure or Executive Performance Disclosure.[118] The Guidance, however, does not distinguish among its Policy Disclosure, Executive Performance

[114] Guidance, *supra* note 48, at 42,888 (ellipses in original and added).

[115] Adopting Release, *supra* note 29, 48,138.

[116] *Id.* (quoting from Guidance, *supra* note 48, at 42,889) (emphasis added).

[117] 17 C.F.R. § 229.402(k)(2) (2004).

[118] *Id.*

Disclosure, and CEO Disclosure. The following example is positively cited in the SEC's criteria discussion:

> [T]he annual incentive compensation plan is funded from a pre-set portion of the Company's net income, which exceeds a threshold return on equity. The percentage and threshold are established at the beginning of the fiscal year. Individual awards for senior management are based upon pre-determined percentages of the total pool based on the individual's position and the Committee's assessment of such individual's contribution in such position. [This is Policy Disclosure]. In 1992, the threshold return on equity was increased from 11% to 12%, while the total management incentive pool was held at 8.5% of net income earned in excess of the level required to meet the threshold return on equity. . . . [This is Executive Officer Performance Disclosure]. At the same time, because of increased earnings and a higher return on equity, the total award to the CEO increased 40%. In 1993, the Company has again increased the return on equity threshold . . . to 13% [This is CEO Performance Disclosure].[119]

The Guidance continues, "[a] problem in many reports was the failure to identify the specific criteria or factors used." Again the Guidance does not point out that "factors and criteria" are only required for a discussion regarding the CEO. The language and examples used in the Guidance suggest that the SEC might have been attempting to expand the "factors and criteria" requirement to other sections of the Report. However, the SEC never specifically stated as much. Furthermore, such a broad interpretation of the rules by the SEC would be contrary to the following compromise the SEC reached a year earlier when it formally adopted the Reports:

> The Board Compensation Committee Report has been retained, but revised to limit the description of performance factors on which the Committee specifically relied to the compensation of the CEO

[119] Guidance, *supra* note 48, at 42,889 (ellipses in original).

> alone, together with a discussion of the Committee's general policies with respect to executive officer compensation.... In addition, language in the proposal ... has been revised to make it clear that the mandated disclosure is solely with respect to corporate performance criteria (e.g., profitability, sales growth, return on equity, market share)[120] on which the Committee relied in reaching its decision concerning CEO compensation.[121]

Also confusing is the first instruction to Item 402(k), which cautions that "[b]oilerplate should be avoided in describing factors and criteria underlying awards or payments of executive compensation in the statement required."[122] Again, the SEC is referring to "factors and criteria" in connection with executive compensation, although it specifically chose to use those terms in the rules only in connection with CEO compensation. Indeed, the rules were "revised to make it clear that mandated disclosure is solely with respect to corporate performance criteria ... concerning CEO compensation."[123] Accordingly, the SEC's Guidance and instruction in this area do not seem to comport with its rules.

Another example of the SEC's commingling of terminology can be seen in the following passage:

> Several reports have attempted to satisfy the requirement to disclose the bases for compensation and its relation to corporate performance with a long laundry list of items considered by the Committee

[120] Interestingly, a similar parenthetical is used later in the adopting release in connection with the "performance measures" the Committee considered with respect to executives' compensation. "[A] discussion is required of the compensation policies with respect to the registrant's executive officers, including the extent to which such compensation (in the aggregate) is performance-related, and the performance measures that are considered (e.g., sales, earnings, return on assets, return on equity or market share)." Adopting Release, *supra* note 29, at 48,138.

[121] *Id.* at 48,127.

[122] 17 C.F.R. § 229.402(k), Instruction 1 (2004).

[123] Adopting Release, *supra* note 29, at 48,127.

> without any discussion of the specific factors. If the laundry list simply represents a practice of subjective, informal compensation policies and practices, the report should clearly so state.[124]

The only requirement to "disclose the bases of compensation" relates to CEO Performance Disclosure.[125] However, the SEC does not make this distinction in the above passage. Indeed, the waters are further muddied by the SEC's subsequent reference to "policies," for which no discussion of "bases" or "factors" is required by the rule.[126]

The SEC crafted the Report rules with the intent to "allow each Compensation Committee to tell its particular story in its own way. The generality of the requirement is intended to accommodate the variety of compensation policies and practices and measures of company performance used by reporting companies."[127] Unfortunately, as can be seen in the section that follows, the way Committees are choosing to tell their stories is overwhelmingly unresponsive to the rules. The "generality" the SEC refers to has apparently led to confusion. While the companies could undoubtedly have produced higher quality disclosures, in fairness to them, the SEC rules and Guidance are not very clear. Accordingly, this Article proposes a "Compensation Committee Report Guide," which is intended to serve as road map to complying with the Report rules as to each specific

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[124] Guidance, *supra* note 48, at 42,889-90. (Emphasis added).

[125] 17 C.F.R. § 229.402(k)(2) (2004).

[126] 17 C.F.R. § 229.402(k) (2004). Perhaps the SEC is trying to imply that the Committee must separately identify its Policy Disclosure. However, this is not one of the "Format" requirements appearing in the Guide, and the Compensation Committee Report Guide suggests the exact opposite to be the case: "Since 1996, Policy Disclosure has evolved further toward what the Commission has been pushing for all along—a good discussion of cash-based policies and how they work, together with an interweaving of Performance Disclosure throughout the Report." GUIDE TO COMPENSATION COMMITTEE REPORTS, *supra* note 54, at 4-20.

[127] *Id.* at 9.

criterion, while, at the same time, allowing the Committee to "tell its particular story in its own way."[128]

V. TEN WIDELY HELD COMPANIES' 2002, 2003, AND 2004 COMPENSATION COMMITTEE REPORTS

Ten widely held companies'[129] 2002, 2003, and 2004 Reports are evaluated below utilizing the framework provided by Item 402(k). Because 2003 Reports are the first Reports Committees issued after the passage of Sarbanes-Oxley, 2003 Reports are analyzed in the greatest detail. Specifically, each company's 2003 Report is evaluated with respect to the quality (or absence) of the following disclosures:

> <u>Policy Disclosure</u>: The Committee's compensation policies regarding all of the company's executive officers (including the "Named Executive Officers").[130]
>
> <u>Performance Disclosure—Executive Officers</u>: The Committees' discussion of the specific relationship of corporate performance to executive compensation for the last fiscal year, including the extent to which compensation, in the aggregate, is performance-

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[128] *See infra* Appendix A: Compensation Committee Report Guide.

[129] These companies are ten of the twenty companies on CNN/Money's "Widely Held Stocks" list, *available at* http://money.cnn.com/markets/widelyheld.html (last visited Apr. 6, 2004). These companies were selected without any prior knowledge of the content of the companies' Reports. The number of companies included in this Article is primarily a function of the availability of 2004 Reports (not all companies had filed 2004 proxy statements with the SEC at the time of this writing) and of the intended scope of the Article. A cursory review of the other companies' Reports yielded results similar to those discussed in this section.

[130] The SEC defines "Named Executive Officers" as the CEO plus the Company's other four most highly compensated executive officers. "Status and compensation levels in the last completed fiscal year will determine the identity of the named executive officers for all Item 402 disclosure, both tabular and narrative." Adopting Release, *supra* note 29, at 48,129. A separate discussion of the Named Executive Officers is not required. Adopting Release, *supra* note 29, at 48,128.

> related.[131] As with Policy Disclosure, the Committee should also disclose which performance measures the Committee considered (e.g., sales earnings, return on assets, return on equity, or market share).[132]
>
> Performance Disclosure—CEO: The Committee's specific discussion of the relationship of the company's performance to the CEO's compensation for the last completed fiscal year.[133]
>
> This discussion is also required to include "each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based."[134]
>
> Other CEO Factors and Criteria: The Committee's bases for the CEO compensation for the last completed fiscal year, including the "factors and criteria" upon which the CEO's compensation was based.

Each company's 2002 and 2004 Reports are then compared to its 2003 Report. As detailed below, Sarbanes-Oxley has had a negligible, perhaps even non-existent, impact on the quality of Reports.

A. Agere Systems[135]

1. Policy Disclosure

Agere Systems' Report contains a rather extensive discussion on its "executive compensation philosophy," which, in large part, actually pertains to its whole employee group. The section specifically dealing with executive officers states that the Committee targets "overall

[131] Adopting Release, *supra* note 29, at 48,138.

[132] *Id.* This requirement elicits disclosure that overlaps with the Policy Disclosure, but its specific performance measures go beyond the Policy Disclosure. *See also Insights Compensation Committee Reports*, *supra* note 40, at 14.

[133] 17 C.F.R. § 229.402(k)(2) (2004).

[134] *Id.*

[135] AGERE SYSTEMS INC., 2003 PROXY STATEMENT 22-25 (2003).

compensation levels between the 50th and the 75th percentile of our comparison group."[136] Compensation above competitive levels should come from the variable portion of the executives' compensation packages, not from raises in their base salaries. Base salaries are targeted to be competitive with similar positions at comparable companies. Retaining senior managers and granting them stock ownership is essential.

2. Performance Disclosure—Executive Officers

The Report separates compensation into three components: base salary, short-term bonuses and long-term incentives. Executive Officer Performance Disclosure is adequately addressed in each category.

The Committee did not give raises to any executive officer due to difficult financial and market conditions. The Committee set quarterly bonus targets for 2002, which were tied to achieving quarterly revenue, operating income, and cash flow targets. Although some targets were met, the Committee chose not to award bonuses due to the company's difficult financial position. One executive officer was awarded a stock option grant for being promoted.

3. Performance Disclosure—CEO

The CEO did not receive a raise or bonus; therefore, a discussion of how CEO compensation and corporate performance were related was not warranted. The Committee cites adverse financial and market conditions.

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[136] *Id.* at 23. The Report must include "both the nature of the group with which the Committee is comparing itself and at what level in the group the company places itself" where compensation is based on the Committee's assessment of competitive rates. While the examples used to illustrate this requirement seem to implicate Policy Disclosure, the SEC's comments are aimed at Performance Disclosure (i.e., the actual "level of compensation paid or awarded" for the last year), as opposed to Policy Disclosure (the guidelines the Committee uses to base its decisions from year-to-year). Guidance, *supra* note 48, at 42,888.

4. Other CEO Factors and Criteria

The Report mentions the CEO's leadership and ability to react quickly to adverse market conditions.

5. As compared to 2002[137]

The 2002 Report's CEO Disclosure fails to comply with the SEC's rules. The 2002 Report mentions an option grant to its CEO covering 3,435,630 shares by referring to non-performance-based stock options without addressing how the size of the award was determined.[138] The 2002 Report also cites an additional option grant by Lucent (the company that "spun-off" Agere Systems in 2001) to the CEO covering 750,000 Lucent shares and 200,000 Lucent restricted stock units for which the Committee gives no explanation. Since similar compensation was not awarded for fiscal 2002, Agere System's 2003 Report did not have the same issues.

6. As compared to 2004[139]

The 2004 Report improves on the 2003 Report in certain areas. Policy Disclosure adds a reference to non-financial corporate performance measures. "Medium Term Incentives" is a new component of the compensation system. Although base salary is not related to corporate performance, the other components of executive compensation appear to be responsive to the SEC's rules.

CEO Performance Disclosure, however, falls short of complying with the SEC's rules. The Committee awarded the CEO stock options covering 2,000,000 shares, which the Committee believes gives the CEO "the ability to achieve long term compensation that was competitive with long term

[137] AGERE SYSTEMS INC., 2002 PROXY STATEMENT 22-24 (2002).

[138] Guidance, *supra* note 48, at 42,889 (The SEC negatively cites an example of a company that grants stock options to "retain and motivate executives" but does not "address how the size of the award was determined.").

[139] AGERE SYSTEMS INC., 2004 PROXY STATEMENT 20-23 (2004).

compensation packages offered by members of our compensation comparison group. . . ."[140] No corporate performance measures, quantitative or qualitative, are discussed. Neither does the Committee discuss what it means by "competitive."[141] In discussing the CEO's "final bonus," the Committee took into account a "wide range of measures," including "financial measures such as . . ." and "non-financial measures, such as. . . ."[142] The Report rules, however, require the Committee to discuss each measure of corporate performance, not selections from a laundry list.[143]

B. AT&T[144]

1. Policy Disclosure

The Committee's clearly presented "Compensation Philosophy and Objectives" are based on competitive, performance- and equity-based executive compensation. The three key components of the company's compensation program are base salary, short-term incentives (i.e., annual bonus), and long-term incentives (e.g., stock options).

The Committee's more concrete policies are interspersed throughout the other sections of the Report in connection

[140] *Id.* at 24.

[141] "A problem in many reports was the failure to identify the specific criteria or factors used. . . . In the future . . . registrants will be asked to justify the non-disclosure. . . ." Guidance, *supra* note 48, at 42,889.

[142] AGERE SYTEMS INC., *supra* note 139, at 23.

[143] "Several reports have attempted to satisfy the requirement to disclose the bases for compensation and its relation to corporate performance with a long laundry list of items considered by the Committee without any discussion of the specific factors. If the laundry list simply represents a practice of subjective, informal compensation policies and practices, the report should clearly so state. The report should discuss the relative importance of each of the factors, and how the individual factors relate to the compensation decisions ultimately made." Guidance, *supra* note 48, at 42,889-90.

[144] AT&T CORP., 2003 PROXY STATEMENT 19-21 (2003).

with its Performance Disclosure.[145] Raises recognize sustained performance but funding is sensitive to market movement and corporate performance. Bonuses are based on key targets for revenue, earnings, and certain qualitative measures, subject to a minimum performance threshold. As for long-term incentives, stock options and performance shares, they are awarded based on "competitive market grant levels for similar positions." Specifically, performance shares are awarded based on certain corporate performance measures as compared to S&P 500 peer group companies; stock options are based on surveys of competitive grant levels; and restricted stock is awarded primarily for the purposes of retention.[146]

2. Performance Disclosure—Executive Officers

The Committee does not discuss the extent to which, if any, executives received raises. Neither does the Committee discuss the extent to which, if any, the executives received bonuses. Elsewhere in the proxy statement, it is evident that Named Executive Officers, other than the CEOs, received bonuses ranging from $525,000 to $1,200,000. Salary increases for executives other than the CEOs are not mentioned. There is no discussion of any kind on the relationship between corporate performance and executives' raises or bonuses.

As with raises and bonuses, the Committee does not discuss the extent to which, if any, stock options or shares of restricted stock were awarded. Elsewhere in the proxy

[145] Guide to Compensation Committee Reports, *supra* note 54, at 4-20. ("Since 1996, Policy Disclosure has evolved further toward what the Commission has been pushing for all along—a good discussion of cash-based policies and how they work, together with an interweaving of Performance Disclosure throughout the Report.").

[146] An example of a company that grants stock options with the intent to "retain and motivate executives" but does not "address how the size of the award was determined" is negatively cited by the SEC. Addressing how the size of the award *was* determined is a matter of Performance Disclosure. Guidance, *supra* note 48, at 42,889.

statement, it is evident that Named Executive Officers, other than the CEOs, received stock option awards covering shares of common stock ranging from 632,747 to 284,736 shares. No restricted stock appears to have been awarded. There is no discussion of any kind on the relationship between corporate performance and executives' awards of stock options or restricted stock.

Performance shares awards are adequately addressed. Executives received performance share awards based on a "three-year cumulative earnings per share and revenue results against pre-established targets and relative shareholder return, as measured against S&P 500 peer group companies." Awards were made based on the company's actual performance over that period of time. Accordingly, the Committee only discussed the "specific relationship of corporate performance to executive compensation" for one of the at least three components of the executives' compensation that was awarded them.[147] The Committee's selectivity renders this portion of the Report unresponsive.

3. Performance Disclosure—CEO

The company experienced a CEO succession during 2002. Both CEOs are discussed. The successor, David W. Dorman, was awarded a raise, a $2,000,000 bonus, a $2,500,000 "transaction bonus," stock options covering 1,247,416 shares of common stock, and 51,174 performance shares. The Committee attributes Mr. Dorman's bonus to an unspecified level of achievement of "targeted financial measures" and "certain operational objectives." This is the type of "general non-disclosure" that the SEC has found to be "uninformative."[148]

The Committee discusses the relationship between the company's performance and Mr. Dorman's "transaction bonus" by citing the successful completion of a division spin-

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[147] 17 C.F.R. § 229.402(k)(1) (2004).

[148] Guidance, *supra* note 48, at 42,889.

off and subsequent merger. The Committee did not discuss the relationship between corporate performance and Mr. Dorman's award of stock options or performance shares. Accordingly, there is no discussion of "each measure of the registrant's performance" upon which Mr. Dorman's compensation was based.[149] Again, the Committee is responsive with respect to only one of many compensation components, which is far from the type of discussion required of the Report.

Mr. Dorman's predecessor, C. Michael Armstrong, was the company's most highly compensated officer for the previous year. Like that of Mr. Dorman, Mr. Armstrong's bonus was based on an unspecified "level of achievement on certain operational objectives." The Committee also noted Mr. Armstrong's "management of a significant restructuring plan" in awarding him a $3,510,000 bonus. The Committee additionally awarded Mr. Armstrong a $2,500,000 "transaction bonus" for his "key role in the successful completion" of the AT&T Broadband/Comcast merger. As with its discussion of Mr. Dorman's compensation, the Committee's discussion of Mr. Armstrong's compensation is the type of "general non-disclosure" that the SEC has found to be "uninformative."[150]

4. Other CEO Factors and Criteria

The Committee cites Mr. Dorman's "leadership" and his "key role" during a time of transition.

5. As compared to 2002[151]

As evident in its shortcomings, the 2003 Report is not an improvement on the 2002 Report. The 2002 Report is

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[149] 17 C.F.R. § 229.402(k)(2) (2004).

[150] Guidance, *supra* note 48, at 42,889.

[151] AT&T CORP., 2002 PROXY STATEMENT XIV-23 – XIV 27 (2002).

equally ambiguous and uses phrases like "performance above threshold but below target."[152]

6. As compared to 2004[153]

CEO Performance Disclosure is equally non-responsive to the SEC's rules. For example, the Committee based the CEO's $2,649,000 bonus on the company's "achievement of certain performance that exceeded targeted financial measures, and the level of achievement on certain operational objectives." Additionally, the CEO was granted stock options covering 1,050,000 shares and restricted stock with a grant-day value of $2,853,000 without an explanation of any kind.

C. AT&T Wireless[154]

1. Policy Disclosure

The Report contains discussions of the company's "Compensation Policy and Objectives," as well as its "Compensation and Practices." These areas of the Report clearly set forth the company's "compensation program," which focuses on "both short- and long-term performance as measured by the Company's financial results and value creation for stakeholders." The fiscal 2002 program components were base salary, annual cash bonus, and long-term incentives (e.g., stock options and restricted stock units).

2. Performance Disclosure—Executive Officers

The Committee determines base salaries by "an evaluation of individual performance" and consideration of

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[152] *Id.* At XIV-27 (the Committee's discussion of the relationship between the company's performance and the $2,148,000 bonus the Committee awarded the CEO).

[153] AT&T CORP., 2004 PROXY STATEMENT 29-32 (2004).

[154] AT&T WIRELESS SERVICES, INC., 2003 PROXY STATEMENT 12-14 (2003).

median salaries at benchmark companies. The SEC has stated that if a Committee chooses to base its compensation award on an assessment of competitive rates, then the Committee "should clearly indicate, for each item said to be based on competitive rates, both the nature of the group with which the Committee is comparing itself and at what level in the group the company places itself."[155] The Committee stated that it considers median salaries but does not indicate at what level, in relation to that median, its executives are compensated. Neither does the Committee discuss the nature of the "benchmark companies" against which its comparisons were made. Three executive officers are compensated "in accordance with the terms of their employment agreements."[156] The Committee does not discuss the extent to which, if any, those agreements relate the compensation of those executives' compensation to corporate performance.

Executives are eligible for cash bonuses based on achievement of "performance targets." Performance measures included service revenue, EBITDA, and strategic business goals. The Committee discussed the manner in which the size of the awards is determined. The Committee disclosed that it reset downward the targets for the second half of the year[157] and ultimately awarded payments ranging from 69.3% to 112.9% of the revised target award opportunity. This portion of the Report appears responsive.

Unfortunately, the Committee reverts to ambiguity in its discussion of stock options. The Committee discusses its general philosophy on stock options and simply states that stock options were awarded to executives. The SEC has directly disapproved of this type of treatment. "In discussing

155 Guidance, *supra* note 48, at 42,888.

156 *See* AT&T WIRELESS, *supra* note 154, at 13.

157 *Id.* at 42,889. ("Where an award is made under a performance-based plan notwithstanding failure to meet the relevant performance criteria, the report should disclose the waiver or adjustment of the relevant performance targets and the bases for the determination nonetheless to award such compensation."). *Id.* The Committee fulfilled this requirement.

long-term incentive compensation, a number of reports focused on the philosophy of the incentive plan and the eligibility criteria, but failed to address how the size of the award was determined."[158] Elsewhere in the proxy statement, it is evident that Named Executive Officers, other than the CEO, received stock option awards covering shares of common stock ranging from 350,000 to 800,000 shares.

3. Performance Disclosure—CEO

The Committee included its discussion of the CEO in with its discussion of the other executives, on a component-by-component basis. As with the other executives, the CEO's "target award" is sufficiently discussed. With respect to his base salary, however, the Committee cites comparable CEO salaries and "internal goals regarding business success." Likewise, the Committee awarded the CEO a stock option grant covering 1,500,000 shares with no discussion of how the award related to the company's performance. There is no description of "each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based."[159] This is representative of the lack of specificity the SEC has bemoaned, particularly in the area of CEO disclosure, "for which more individualized disclosure is required by the rule."[160]

4. Other CEO Factors and Criteria

The Committee refers to "leadership" when discussing its determination of the CEO's base salary.

[158] *Id.*

[159] 17 C.F.R. § 229.402(k)(2) (2004).

[160] Guidance, *supra* note 48, at 42,888.

5. As compared to 2002[161]

Although the Reports are substantially similar, the 2002 Report has a separate heading for "CEO Compensation," under which each component of the CEO's compensation can be found.[162]

6. As compared to 2004[163]

Again, CEO compensation is not separately discussed. Instead, the Committee lumps CEO Performance Disclosure into its discussion of the various components of overall executive compensation. In doing so, the Committee winds up failing to fulfill the requirements of CEO Performance Disclosure. For instance, the Committee's statement that awards were made "based on achievement of previously established key performance metrics, which for 2003 included service revenue and free cash flow" may be adequate Executive Officer Performance Disclosure. But it falls short of meeting the CEO Performance Disclosure requirements, "for which more individualized disclosure is required by the rule."[164]

D. Avaya[165]

1. Policy Disclosure

The Committee includes discussions of its "Compensation Philosophy" and the "Compensation Programs." The Committee's philosophy is to provide competitive compensation and to emphasize pay for performance. Compensation programs are comprised of base salary, a

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[161] AT&T WIRELESS SERVICES, INC., 2002 PROXY STATEMENT 11-13 (2002).

[162] While listing CEO compensation under a separate heading is not required by any SEC rule, it makes the information easier to access.

[163] AT&T WIRELESS SERVICES, INC., 2004 PROXY STATEMENT 49-52 (2004).

[164] Guidance, *supra* note 48, at 42,888.

[165] AVAYA INC., 2003 PROXY STATEMENT 28-29 (2003).

bonus plan, and an equity-based program. The Policy Disclosure is responsive.

2. Performance Disclosure—Executive Officers

No cash bonuses were paid because corporate performance fell short. The Committee discusses its policy for awarding equity-based awards (stock options and restricted stock units) on both an aggregate and an individual basis. The Committee then goes on to report the terms of all of the stock options it awarded in 2002 and does not discuss how many were actually awarded.[166] Moreover, the all-important discussion of the relationship between those awards to corporate performance is missing. In fact, the Committee does not mention any performance measures that were considered.[167]

3. Performance Disclosure—CEO

The CEO did not receive a cash bonus, but he did receive a raise based on CEO pay at comparable companies. The Committee also awarded the CEO stock options covering 400,000 shares and 80,000 restricted stock units. The Committee only states that these awards were made "consistent with our equity-based program." As with the executives' stock option awards, the Committee does not discuss the relationship between the CEO's stock option award and corporate performance. Neither does the Committee mention any performance measures, qualitative or quantitative, that were considered.[168] Accordingly, the

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[166] It is not enough to discuss the philosophy and eligibility criteria of an incentive plan without addressing how the size of the award *actually made* was determined. Guidance, *supra* note 48, at 42,889.

[167] With respect to compensation of executive officers, "a discussion is required of the . . . performance measures that are considered (e.g., sales, earnings, return on assets, return on equity, or market share)." Adopting Release, *supra* note 29, at 48,138.

[168] "The committee shall include a specific discussion of the relationship of the registrant's performance to the CEO's compensation for the last completed fiscal year, describing each measure of the registrant's

Committee's discussion of CEO compensation, "for which more individualized disclosure is required by the rule,"[169] is uninformative and does not fulfill Item 402(k)(2)'s requirements.

4. Other CEO Factors and Criteria

The Committee also considered CEO compensation in "other publicly owned and similarly sized companies in comparable industries."

5. As compared to 2002[170]

The two Reports are substantially similar. The CEO received stock options covering 3,000,000 shares and 202,500 restricted stock units "designed to provide incentive throughout the term of the option." The Committee, however, does not discuss how it determined the number of shares that it awarded.[171]

6. As compared to 2004[172]

The Committee's policies have been significantly reworked but are still informative. Unfortunately, the Committee decided not to discuss CEO compensation separately, as it had in the past. Instead, the Committee lumps CEO Performance Disclosure into its discussion of overall executive compensation. In doing so, the Committee winds up failing to fulfill the requirements of CEO Performance Disclosure. For instance, the Committee's statement that it bases "individual grants of equity-based awards on various factors, including demonstrated sustained

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performance, whether qualitative or quantitative, on which the CEO's compensation was based." 17 C.F.R. § 229.402(k)(2) (2004).

[169] Guidance, *supra* note 48, at 42,888.

[170] AVAYA INC., 2002 PROXY STATEMENT 32-33 (2002).

[171] It is not enough to discuss the philosophy and eligibility criteria of an incentive plan without addressing how the size of the award *actually made* was determined. Guidance, *supra* note 48, at 42,889.

[172] AVAYA INC., 2004 PROXY STATEMENT 22-24 (2004).

performance and each executive officer's ability to contribute to Avaya's future success" probably falls short of adequate Executive Officer Performance disclosure.[173] However, that type of discussion falls well short of adequate CEO Performance Disclosure "for which more individualized disclosure is required by the rule."[174]

E. Cisco Systems[175]

1. Policy Disclosure

The Committee discusses its "Compensation Philosophy and Objectives," as well as the "Compensation Components and Process." The Committee considers company performance, individual contributions, and peer companies' compensation. The Committee seeks to provide significant equity-based, long-term incentives. The major components of executive compensation are base salary; variable incentive awards; and long-term, equity-based incentive awards. This portion of the Report appears to be responsive.

2. Performance Disclosure—Executive Officers

While the Committee indicates where in relation to peer companies it targets base salaries, there is no discussion of how the salaries were actually set for the previous year.

The Committee discusses its policy of tying executive compensation to the company's achievement of financial performance targets that are established at the beginning of the year. The executive's contribution, customer satisfaction, and market share are also considered. The company's performance is measured using both revenue and profit. Once threshold levels of corporate performance are reached,

[173] It is not enough to discuss the philosophy of an incentive plan and the eligibility criteria without addressing how the size of the actual award was determined. Guidance, *supra* note 48, at 42,889.

[174] Guidance, *supra* note 48, at 42,888.

[175] CISCO SYSTEMS, INC., 2002 PROXY STATEMENT 16-18 (2002). All of the "2003 Reports" herein, including this one, cover the 2002 fiscal year.

the Committee utilizes a formula to calculate each executive's incentive pay. For 2002, the company exceeded its targets and paid awards to reflect that performance as well as customer satisfaction and individual accomplishment. This section of the Report appears to be responsive.[176]

The Committee discussed its policy of determining the size of long-term, equity based-incentives according to each executive's position, performance, potential, comparable awards, and the number of unvested options held by each executive officer.[177] In 2002, the Committee made grants under the "1996 Stock Incentive Plan," which presumably embodies the policy discussed immediately above. To the extent the Committee discussed "how the size of the award was determined," this section is responsive.[178]

3. Performance Disclosure—CEO

For 2002, the CEO's base salary was $1. The CEO requested that he not be awarded a "variable incentive award," as well. Additionally, the CEO waived his rights to an option grant for 2,000,000 shares. Consequently, that grant has been cancelled and is no longer outstanding.

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[176] Although the SEC seems to suggest that the Committee should discuss the specific criteria and factors for Executive Officers' Compensation Disclosure (Guidance, *supra* note 48, at 42,889), under Item 402(k), that discussion is only specifically required with respect to the CEO's Performance Disclosure. Moreover, the Adopting Release clearly indicates that only a discussion is required of "the extent to which such compensation (in the aggregate) is performance-related, and the performance measures that are considered (e.g. sales, earnings, return on assets, return on equity or market share)." Adopting Release, *supra* note 29, at 48,138.

[177] Companies that consider certain options grants "less as compensation and more as a different incentive mechanism" were asked by the SEC to disclose whether "the Committee considered the amount and terms of options and restricted stock already held by the executive officer." Guidance, *supra* note 48, at 42,889.

[178] It is not enough to discuss the philosophy of an incentive plan and the eligibility criteria without addressing how the size of the award actually made was determined. Guidance, *supra* note 48, at 42,889.

However, by reference to another part of the Proxy Statement, it is evident that the CEO received stock option awards covering 4,000,000 additional shares.[179] That figure is not disclosed in the Report.

The Committee states that the CEO's options were awarded "based upon his performance and leadership with the Company." Upon an initial reading, this reference seems to refer to the award of the options covering 2,000,000 shares that the CEO waived. However, after consulting other parts of the Proxy Statement, it is clear that the Committee is referring to the full award of stock options covering all 6,000,000 shares. It seems disingenuous of the Committee to discuss the 2,000,000 waived shares without mentioning the other 4,000,000 that were accepted. There is no discussion of each measure of corporate performance upon which the original grant was made.[180] Neither does the Committee discuss "how the size of the award was determined."[181]

4. Other CEO Factors and Criteria

The Committee referred to the CEO's "performance and leadership" in its discussion of the stock option award.

5. As compared to 2002[182]

The two Reports are very similar. Again, the Committee states that the CEO's options were awarded "based upon his performance and leadership with the Company." No figure is disclosed in the Report, but by reference to another portion of the Proxy Statement, it is evident that the CEO received stock option awards covering 6,000,000 shares.[183] As with

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[179] CISCO SYSTEMS, INC., *supra* note 175, at 19.

[180] 17 C.F.R. § 229.402(k)(2) (2004).

[181] In discussing long-term incentive compensation, Committees must discuss how the size of the award was determined, not just the incentive plan's philosophy or eligibility criteria. Guidance, *supra* note 48, at 42,889.

[182] CISCO SYSTEMS, INC., 2001 PROXY STATEMENT 10-12 (2001). All of the "2002 Reports" herein, including this one, cover the 2001 fiscal year.

[183] *Id.* at 13.

the Committee's 2003 CEO Performance Disclosure, this is totally non-responsive.[184]

6. As compared to 2004[185]

"Company" has been changed to "Cisco." Otherwise, the Reports are strikingly similar. The Committee again awarded the CEO stock options "based upon his performance and leadership with the Company." No figure is disclosed in the Report, but by reference to another portion of the Proxy Statement, it is evident that the CEO received stock option awards covering 4,000,000 shares.[186] As with the Committee's 2003 CEO Performance Disclosure, this is totally non-responsive.[187]

F. Citigroup[188]

1. Policy Disclosure

The Committee's "Statement of Philosophy" indicates that the Committee measures executives' performance based on the performance of a business unit or the entire company, depending on the nature of the executive's responsibilities. The Committee lists a number of corporate measures that it considers. The Committee strongly encourages stock ownership by directors and senior management. Executive compensation consists of base salary, discretionary incentive and retention awards (cash and restricted or deferred stock)

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184 In discussing long-term incentive compensation, Committees must discuss how the size of the award was determined, not just the incentive plan's philosophy or eligibility criteria. Guidance, *supra* note 48, at 42,889.

185 CISCO SYSTEMS, INC., 2003 PROXY STATEMENT 21-23 (2003). All of the "2004 Reports" herein, including this one, cover the 2003 fiscal year.

186 *Id.* at 24.

187 In discussing long-term incentive compensation, Committees must discuss how the size of the award was determined, not just the incentive plan's philosophy or eligibility criteria. Guidance, *supra* note 48, at 42,889.

188 CITIGROUP INC., 2003 PROXY STATEMENT 24-26 (2003).

and stock option grants. Competitors' pay practices are periodically consulted. The Policy Disclosure appears to be responsive.

2. Performance Disclosure—Executive Officers

Executive bonuses are paid according to a Compensation Plan,[189] pursuant to which executive bonuses are contingent on the company first achieving a 10% return on equity. The bonus pool is then based on the extent to which return on equity exceeds 10%. For 2002, the maximum bonus pool was $199.6 million, of which $17.1 million was awarded. This portion of the Reports appears to be responsive.[190]

3. Performance Disclosure—CEO

The CEO informed the Committee that he would not accept any cash bonus or restricted stock award. However, the Committee believed that "recognizing the value of Sanford Weill's efforts is important; therefore, the Committee granted Sanford Weill a supplemental stock award." There is no other discussion regarding this award in the Report. By reference to another section of the Proxy Statement, it is evident that the CEO received stock options covering 1,044,229 shares.[191] The Committee did not discuss "each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based."[192] Accordingly, the Committee's discussion of CEO compensation, "for which more individualized disclosure is required by the rule,"[193] does not fulfill Item 402(k)(2)'s requirements.

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[189] One executive's compensation is based entirely on an employment agreement and is therefore not subject to the Compensation Plan.

[190] The Report also discusses, in a cursory fashion, compensation of individual officers. The quality of those discussions would not suffice if they related to CEO Performance Disclosure.

[191] CITIGROUP, INC., *supra* note 188, at 27.

[192] 17 C.F.R. § 229.402(k)(2) (2004).

[193] Guidance, *supra* note 48, at 42,888.

4. Other CEO Factors and Criteria

The Committee referred to the CEO's "leadership" and his "commitment to further improve the Company's corporate governance."

5. As compared to 2002[194]

The 2003 CEO Performance Disclosure may have actually been an improvement over 2002's. In a year when the Committee awarded the CEO a $25,000,000 bonus[195] (which one must refer to another part of the Proxy Report to ascertain), the Committee merely states that the CEO's leadership "was central to [last year's] performance."[196] The discussion of corporate performance is not specific to the CEO. This is another example of the type of "lack of specificity" that has been "a particular problem with respect to CEO compensation."[197]

6. As compared to 2004[198]

The 2004 Report contains an additional disclosure that still falls short of the SEC's rules. In its discussion of executive compensation, the Committee states, "In addition, Charles Prince and Robert Willumstad each received retention awards of restricted stock in July in conjunction with announced succession plans. These awards, valued at approximately $15 million each, were designed to encourage retention of these key leaders."[199] This type of discussion is insufficient because the Committee does not disclose "how the size of award was determined."[200]

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[194] CITIGROUP INC., 2002 PROXY STATEMENT 21-23 (2002).

[195] Among other forms of compensation, the CEO received $16,986,748 in cash and $8,017,669 in restricted stock. *Id.* at 24.

[196] *Id.* at 23.

[197] Guidance, *supra* note 48, at 42,888.

[198] CITIGROUP INC., 2004 PROXY STATEMENT 28-30 (2004).

[199] *Id.* at 29.

[200] In discussing long-term incentive compensation, Committees must discuss how the size of the award was determined, not just the incentive

G. Comcast[201]

1. Policy Disclosure

The Committee's "Compensation Policy" is to provide competitive compensation and to permit executive officers to take an ownership stake in the company. Executive compensation consists of base salary, bonuses, and equity-based incentive compensation. The Committee determines base salary on a competitive basis. Bonuses are awarded pursuant to a bonus plan. Equity-based incentives promote a long-term commitment to improving the company's performance. The Policy Disclosure appears to be responsive.

2. Performance Disclosure—Executive Officers

For fiscal 2002, salaries were increased pursuant to the company's standard practice of basing salaries on a competitive basis. The Committee considers its comparison group to be broader than its peer index group. The Committee does indicate how, in relation to its comparison group, salaries are set.[202] When a portion of compensation is awarded based on competitive rates, "the report should clearly indicate . . . both the nature of the group with which the Committee is comparing itself and at what level in the group the company places itself."[203] The Committee's discussion of executive salaries does not appear to meet this standard.

Bonuses were awarded pursuant to a bonus plan, which is structured around annual cash flow performance targets.

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plan's philosophy or eligibility criteria. Guidance, *supra* note 48, at 42,889 (SEC negatively citing reports that "said no more than: Stock options are the principal vehicle for payment of long-term compensation. This component of compensation is intended to retain and motivate executives to improve stock market performance. . . .").

[201] COMCAST CORP., 2003 PROXY STATEMENT 47-51 (2003).

[202] The "Prior Committee" generally awarded total compensation in the fiftieth to seventy-fifth percentile. *Id.* at 48.

[203] Guidance, *supra* note 48, at 42,888.

Based on 2002 cash flow, 100% of the target bonuses were earned in the amount of 50% of base salary. Executive officers also received "supplemental cash bonuses" in a like amount. No terms of the "supplemental cash bonuses" are disclosed; therefore, their relationship to corporate performance has not been disclosed.

Stock options awarded to executive officers were generally based "on a proportional relationship [to] the expected cash compensation of the option recipients, taking into account prior option grants . . . ."[204] The Committee does not indicate how much the "expected compensation of the option recipients" was and how options actually awarded relate to that compensation, proportionally.[205]

3. Performance Disclosure—CEO

The CEO's compensation was based on an employment agreement that was amended in November 2002 when the CEO's salary was increased to $2 million. Under the agreement, the CEO's compensation was initially based on a review of comparable CEO compensation. No mention is made of where in relation to the comparable companies the CEO's compensation was set. When any portion of a compensation package was awarded based on competitive rates, "the report should clearly indicate . . . both the nature of the group with which the Committee is comparing itself and at what level in the group the company places itself."[206] The Committee's discussion of the CEO's compensation does not appear to meet this standard.

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[204] COMCAST CORP., *supra* note 201, at 50.

[205] In discussing a long-term incentive plan, the Committee must discuss how the size of the award *actually made* was determined. Guidance, *supra* note 48, at 42,889.

However, the Committee's discussion is responsive to the SEC's request that Committees disclose whether they considered "the amount and terms of options and restricted stock already held by the executive officer" when awarding options as an "incentive mechanism." *Id.* at 42,890.

[206] Guidance, *supra* note 48, at 42,888.

In discussing the November 2002 amendment and salary increase, the Committee refers to some Other Factors and Criteria (see below) for its decision and states that otherwise the Committee "did not consider specific performance measures in approving or amending the Compensation Agreement." This type of "just say it" approach appears to satisfy SEC requirements for Executive Performance Disclosure.[207] However, more is required when the Committee is discussing its bases for, and factors relating to, CEO compensation. Specifically, the Report "should discuss the relative importance of each of the factors, and how the individual factors relate to the compensation decisions ultimately made."[208]

Additional CEO compensation was awarded under the same bonus plan and supplemental cash bonus plan under which the executives were compensated. However, the Committee does not discuss with any greater detail the relationship between CEO compensation and corporate performance. The same aggregated bonus plan discussion that suffices for executives does not suffice for CEO

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[207] As the Guidance states,

> Clearly, if the compensation policies and practices of the Compensation Committee are general and subjective, in toto, or with respect to certain elements of the compensation package, the report cannot include specificity and objectiveness that is not in fact practiced by the Committee. In such case, the report should state clearly that the policy or practice in question is subjective, not subject to specific criteria."

Guidance, *supra* note 48, at 42,887. *See also* GUIDE TO COMPENSATION COMMITTEE REPORTS, *supra* note 54, at 4-23.

[208] "Several reports have attempted to satisfy the requirement to disclose the bases for compensation and its relation to corporate performance with a long laundry list of items considered by the Committee without any discussion of the specific factors. If the laundry list simply represents a practice of subjective, informal compensation policies and practices, the report should clearly so state. The report should discuss the relative importance of each of the factors, and how the individual factors relate to the compensation decisions ultimately made." Guidance, *supra* note 48, at 42,889-90.

Performance Disclosure, "for which more individualized disclosure is required by the rule."[209] Again, the terms of the supplemental cash bonus plan are not disclosed. This portion of the Report is not responsive.

Lastly, the CEO was awarded stock options covering 750,000 shares. Like the executives' award, the Committee made this award "based on the proportional relationship to the CEO's expected cash compensation for the year and also took into account prior option grants and grants made at the same time to other executive officers of the Company."[210] This is not sufficient CEO Performance Disclosure, "for which more individualized disclosure is required by the rule."[211] Moreover, no indication is given as to what "Mr. Robert's total expected cash compensation" was and how options covering 750,000 shares relates to that compensation, proportionally.

4. Other CEO Factors and Criteria

The Committee referred to the importance of "maintaining the continued active participation of the CEO in the Company's affairs over the periods covered by the Compensation Agreement, the Company's growth and overall performance during the period *prior to 1998*, and the CEO's prior compensation levels during those periods."[212]

5. As compared to 2002[213]

The 2003 Report includes discussion of various restructurings of agreements and personnel that occurred as

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[209] Guidance, *supra* note 48, at 42,889.

[210] While the Committee's discussion is responsive to the SEC's request that Committees disclose whether they considered "the amount and terms of options and restricted stock already held by the executive officer" when awarding options as an "incentive mechanism," the Committee is not relieved from its responsibility "to identify the specific criteria or factors used." Guidance, *supra* note 48, at 42,889.

[211] Guidance, *supra* note 48, at 42,888.

[212] COMCAST CORP., *supra* note 201, at 50 (emphasis added).

[213] COMCAST CORP., 2002 PROXY STATEMENT 21-35 (2002).

a result of the company's acquisition of AT&T broadband. The CEO Performance Disclosure is more extensive and provides more bases for the Committee's decision, but the Committee still shies away from a meaningful discussion of the relationship between the CEO's compensation and the company's previous year's performance.

6. As compared to 2004[214]

The Reports are similar. CEO Performance Disclosure is equally generalized. Again, the Committee adopts a "just say it approach" with respect to the CEO's employment. The Committee repeats its uninformative explanation of another award to the CEO of stock options—this time covering 950,100 shares—by stating that the award was "based on the proportional relationship to Mr. Roberts' expected cash compensation for the year and also took into account prior options grants . . . ."[215] No indication is given as to what "Mr. Roberts' total expected cash compensation" was and how options covering 950,100 shares relates to that compensation, proportionally.

H. Exxon Mobil[216]

1. Policy Disclosure

Executive compensation consists of competitive base salaries, short-term rewards, and long-term incentives. The Committee takes a long-term approach to executive compensation. Each year, the Committee evaluates the company's salary structure based on comparisons to other companies, the company's own business performance, and

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[214] COMCAST CORP., 2004 PRELIMINARY PROXY STATEMENT 48-51 (2004).

[215] The SEC has requested that Committees disclose whether they considered "the amount and terms of options and restricted stock already held by the executive officer" when awarding options as an "incentive mechanism." However, there is no indication that the SEC intended this provision to excuse a discussion of the "the specific criteria or factors used" in awarding the CEO compensation. Guidance, *supra* note 48, at 42,889.

[216] EXXON MOBIL CORP., 2003 PROXY STATEMENT 14-17 (2003).

general economic factors. Comparable companies are United States-based multinational companies. The company targets salary ranges between the median and high end of the survey data. Short-term bonuses, which were awarded to approximately 1300 employees, are determined based on a "laundry list" of factors.[217] Executives' bonuses are based on factors including business results and leadership. Long-term incentives awards are "intended to develop and retain strong management through share ownership and incentive awards that recognize future performance" and are awarded on the same basis as short-term awards. This section of the Report appears to be responsive.

2. Performance Disclosure—Executive Officers

The Committee does not mention whether it actually changed the level of executives' base salaries. Accordingly, there is no discussion of the specific relation of corporate performance to the level of base salaries.

The Committee states that executive bonuses depend "on the executive's individual performance and level of responsibility. Each year, we assess performance based on factors including business results, technical expertise, leadership and management skills."[218] The Committee does not mention the extent to which it awarded short-term incentives to the executives for last year. There is no discussion of the "specific relationship of corporate performance to executive compensation . . . for the last completed fiscal year."[219] Neither does the Committee discuss the "performance measures that are considered (e.g., sales, earnings, return on assets, return on equity or market share)."[220]

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[217] "If the laundry list simply represents a practice of subjective, informal compensation policies and practices, the report should clearly so state." "Laundry lists" do not appear to be insufficient for Policy Disclosure purposes. Guidance, *supra* note 48, at 42,889-90.

[218] EXXON MOBIL CORP., *supra* note 216, at 14.

[219] 17 C.F.R. § 229.402(k)(1) (2004).

[220] Adopting Release, *supra* note 29, at 48,138.

The Committee grants long-term incentive awards to executive officers based on "individual performance and level of responsibility. For this purpose, the Committee measures performance the same way as described above for short term awards."[221] For the same reasons as described above for short-term awards, this rationale is unsatisfactory. The Committee goes on to disclose that the number of shares held by an executive is not a factor in determining subsequent grants.[222]

3. Performance Disclosure—CEO

The amount of the CEO's compensation is not discussed in the Report. One must refer to another part of the Proxy Statement to learn that the CEO received $3,250,000 in salary, $2,160,000 in cash bonus, $2,700,005 settlement of "earnings bonus units," and restricted stock with a grant day value of $17,320,000.

In its much generalized discussion, the Committee remarked it "does not think narrow quantitative measures or formulas are sufficient for determining Mr. Raymond's compensation." The Committee refers to the CEO's the "continued strengthening of the Corporation's worldwide competitive position, and its progress toward long-range strategic goals." According to the SEC, "citing only unspecified performance or strategic goals ... [is] uninformative. In the future, registrants will be asked to justify the non-disclosure. . . ."[223] This is not adequate CEO Performance Disclosure, "for which more individualized disclosure is required by the rule."[224]

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[221] EXXON MOBIL CORP., *supra* note 216, at 15

[222] Committees must disclose whether they considered "the amount and terms of options and restricted stock already held by the executive officer" when awarding options as an "incentive mechanism." Guidance, *supra* note 48, at 42,889.

[223] *Id.*

[224] *Id.* at 42,888.

4. Other CEO Factors and Criteria

The Committee mentioned the CEO's "contributions to Exxon Mobil's business, the size and complexity of the business, and career experience." The Committee also considered the "level of responsibility, his leadership, and his overall contribution as CEO. The Committee believes his total compensation is appropriately positioned relative to the CEOs of US based oil companies and other major US based corporations."

5. As compared to 2002[225]

The Report's content has been significantly overhauled since the 2002 Report. As noted above, however, the 2003 Report's disclosures still fall short. The Committee engaged in similar CEO Performance Disclosure. One must refer to another part of the Proxy Statement to learn that the CEO received \$2,850,000 in salary, \$2,700,000 in cash bonus, \$1,355,130 settlement of "earnings bonus units," "stock options covering 1,050,000 shares," and restricted stock with a nominal grant day value of \$7,424,000.[226]

6. As compared to 2004[227]

The Committee again substantially overhauls the form of its Report but falls short substantively. The Policy Disclosure is significantly enhanced and more background into the terms and purposes of various aspects of executive compensation is provided. The Committee's discussion of short-term incentives this time includes the amount in which grants were awarded and the aggregate performance measures it considered. The amount in which long-term incentives (i.e., restricted stock) were actually awarded executives from 2003 was not discussed. Accordingly, there is no discussion of the "specific relationship of corporate

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[225] EXXON MOBIL CORP., 2002 PROXY STATEMENT 12-15 (2002).

[226] EXXON MOBIL CORP., *supra* note 225, at 16.

[227] EXXON MOBIL CORP., 2004 PROXY STATEMENT 17-20 (2004).

performance to executive compensation ... for the last completed fiscal year."[228]

The Committee includes certain qualifying statements that indicate it is cognizant of the Guidance. For example, the Committee states that it "does not give specific weights these measures" after listing a number of factors it considered in awarding "short-term incentives."[229] With respect to long-term incentives, the Committee stated, "The number of shares held by an executive is not a factor in determining subsequent grants."[230]

CEO Performance Disclosure is simply a shuffling of the words the Committee used in the previous year's Report.[231] Again, the amount of the CEO's compensation is not discussed in the Report. One must refer to another part of the Proxy Statement to learn that the CEO received $3,250,000 in salary; $3,564,000 in cash bonus; $2,700,000 settlement of "earnings bonus units"; and restricted stock with a nominal grant day value of $17,910,000.[232]

I. General Electric[233]

1. Policy Disclosure

The Committee's "Compensation Policies for Executive Officers" involve rewarding superior executive performance

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[228] 17 C.F.R. § 229.402(k)(2) (2004).

[229] "If the laundry list simply represents a practice of subjective, informal compensation policies and practices, the report should clearly so state. The report should discuss the relative importance of each of the factors, and how the individual factors relate to the compensation decisions ultimately made." Guidance, *supra* note 48, at 42889-90.

[230] Committees must disclose whether they considered "the amount and terms of options and restricted stock already held by the executive officer" when awarding options as an "incentive mechanism." Guidance, *supra* note 48, at 42,889.

[231] Because of this type of CEO Performance Disclosure, the SEC noted that the "principal recurring problem was a lack of specificity." Guidance, *supra* note 48, at 42,888

[232] EXXON MOBIL CORP., *supra* note 227, at 21.

[233] GENERAL ELECTRIC CO., 2003 PROXY STATEMENT 19-24 (2003).

that will create long-term investor value and to retain high performers. The basic elements of the executive compensation program are salary and bonus, stock options, restricted stock units ("RSUs"), and "other contingent long-term financial performance awards." The Committee comprehensively discusses the purpose behind each of these components. This portion of the Report is responsive.

2. Performance Disclosure—Executive Officers

Under a separate heading, the Committee discusses the "Key Executive Compensation Actions Last Year." All stock option, RSU and contingent long-term performance awards were made pursuant to a Plan. The Committee also established stock ownership requirements for executives, precluded its top five executives from participating in a salary deferral plan, and recommended the expensing of options to the full board.

The Committee also discussed the "Factors We Considered in Making Specific Compensation Decisions" under a separate heading. The Committee relies upon "judgment, not rigid guidelines or formulas, or short term changes in our stock prices, in determining the amount and mix of compensation elements for each executive officer."[234] The Committee goes on to report numerous factors that affected their judgments.[235] This section of the Report appears to be responsive.

3. Performance Disclosure—CEO

The CEO annual salary, which had been in effect since April 2001, remained at $3,000,000. Immediately after

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[234] *Id.* at 22.

[235] The Guidance recognizes that "[c]learly, if the compensation policies and practices of the Compensation Committee are general and subjective, in toto, or with respect to certain elements of the compensation package, the report cannot include specificity and objectiveness that is not in fact practiced by the Committee." In such instances, "the report should state clearly that the policy or practice in question is subjective, not subject to specific criteria." Guidance, *supra* note 48, at 42,887.

stating the CEO has agreed to forgo a raise until he has satisfied stock ownership requirements, the Committee disclosed that they paid him a $3,900,000 cash bonus. The Committee lists a number of items it considered in determining the CEO's compensation without discussing how the individual factors relate to the compensation decisions ultimately made. However, generalized lists do not satisfy the CEO Performance Disclosure's requirements.

Several reports have attempted to satisfy the requirement to disclose the bases for compensation and its relation to corporate performance with a long laundry list of items considered by the Committee without any discussion of the specific factors. If the laundry list simply represents a practice of subjective, informal compensation policies and practices, the report should clearly so state. The report should discuss the relative importance of each of the factors, and how the individual factors relate to the compensation decisions ultimately made.[236]

The Committee additionally granted the CEO 20,000 RSUs and 1,000,000 stock options. The Committee believes stock options can be an extremely effective incentive for superior performance leading to long-term shareholder value. No mention is made of how these awards relate to corporate performance. This type of disclosure is insufficient: "In discussing long-term incentive compensation, a number of reports focused on the philosophy of the incentive plan and the eligibility criteria, but failed to address how the size of the award was determined."[237]

Finally, the CEO received $6,698,900 under the "2000-2002 contingent long-term performance incentive award described on page 28 below."[238] Page 28 is not part of the Report. Page 28 does, however, contain a fairly thorough discussion of the 2000-2002 program and how the awards actually made relate to corporate performance. The discussion is mainly geared to the other Named Executive

[236] Guidance, *supra* note 48, at 42,889-90.

[237] *Id.* at 42,889.

[238] GENERAL ELECTRIC CO., 2003 PROXY STATEMENT 23 (2003).

Officers, who, by reference to yet another part of the proxy statement one can see, received payouts ranging from $3,095,200 to $10,672,100. The payments were not discussed in the Executive Officers Performance Disclosure. This portion of the Report is unresponsive.

4. Other CEO Factors and Criteria

The Committee considered the CEO's compensation appropriate for the following reasons:

> [H]is role in leading us to solid financial results in an extremely challenging global economic environment; his commitment for the company to be a leader in integrity, transparency and corporate governance at a time of convulsive change in business regulation and investor expectations; and his commitment to shaping an agenda to enhance long-term investor value by accelerating profitable growth, by increasing our use of technology to create value for our customers, by ensuring the company has a strong capital structure, by reorganizing our financial services businesses to increase transparency and effective management for growth in key financial sectors, and by focusing our quality and digitization initiatives on strengthening customer relationships.[239]

5. As compared to 2002[240]

The 2002 Report treats CEO Performance Disclosure in an equally generalized fashion. For example, the entire CEO Performance Disclosure regarding the part-year CEO, who earned $16,075,000 in salary and bonus, reads as follows: "The Committee considered these payments warranted by Mr. Welch's unswerving commitment to transitioning responsibility for the Company to the next generation of

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[239] *Id.* at 22-23.

[240] GENERAL ELECTRIC CO., 2002 PROXY STATEMENT 16-19 (2002).

leadership, and his passionate determination to position the Company for future growth."[241]

GE recently settled an SEC enforcement action relating to GE's description of Mr. Welch's "employment and post-retirement consulting agreement" in GE's 1996 Form 10-K, its 1997 proxy statement and each of its Forms 10-K and proxy statements filed through 2002.[242] The SEC's action was based on Item 402(h)(2) of Regulation S-K's requirement to:

> Describe the terms and conditions of . . . [a]ny compensatory plan or arrangement . . . with respect to a named executive officer, if such plan or arrangement results from the resignation, retirement, or any other termination of such executive officer's employment . . . and the amount involved . . . exceeds $100,000.[243]

The SEC found that GE failed to "fully and adequately describe the terms and conditions of the Agreement" because it did not provide any specific information regarding the "facilities and services" to which Mr. Welch would have access pursuant to the agreement.[244]

Unlike Regulation S-K Item 402(k), which governs the Reports, Item 402(h) pertains specifically to employment contracts and post-employment arrangements with named executive officers. The disclosure required by Item 402(h) is not allowed the same Securities Act and various Exchange Act exemptions from liability that Item 402(k) enjoys.[245] Consequently, the SEC was able to utilize Item 402(h) as the basis for this action even though GE incorporated its description of Mr. Welch's retirement agreement into its Report.

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[241] *Id.* at 18.

[242] *See* General Electric Co., 2004 LEXIS 2174 (Sept. 23, 2004).

[243] 17 C.F.R. § 229.402(h)(2) (2004).

[244] *See* General Electric Co., 2004 LEXIS 2174, at ¶ 14.

[245] For a discussion of these exemptions, see *supra* Part III(E)(2).

6. As compared to 2004[246]

The 2004 Report contains very little language that has been carried over from the previous year's Report. While the 2003 Report was clearly used as a guide, it is apparent that the Committee thought through the contents of its 2004 Report and did not resort to just relying on boilerplate language. The Committee's policies with respect to executive and CEO compensation have been significantly enhanced, as has the Executive Officers Performance Disclosure.

However, CEO Performance Disclosure is still weak. The CEO's $3,000,000 salary and cash bonus of $4,325,000 were attributed to a list of five reasons, each of which has numerous aspects of their own. There is no real discussion of, or weigh attributed to, any aspect of the list. The SEC has specifically disapproved of this type of CEO Performance Disclosure:

> Several reports have attempted to satisfy the requirement to disclose the bases for compensation and its relation to corporate performance with a long laundry list of items considered by the Committee without any discussion of the specific factors. If the laundry list simply represents a practice of subjective, informal compensation policies and practices, the report should clearly so state. The report should discuss the relative importance of each of the factors, and how the individual factors relate to the compensation decisions ultimately made.[247]

Moreover, the Committee's disclosure of the 250,000 "performance share units" does not include a discussion of how the size of that award was determined. While the Committee does an excellent job of discussing how the value of those shares is tied to future corporate performance, that is only half of the equation.[248] The other half is why the

[246] GENERAL ELECTRIC CO., 2004 PROXY STATEMENT 20-25 (2004).

[247] Guidance, *supra* note 48, at 42,889-90.

[248] Guidance, *supra* note 48, at 42,889 (SEC negatively citing example of company that grants stock options to "improve stock market

Committee decided to grant the CEO 250,000 shares instead of, say, 25,000 or 2,500,000 shares.

J. Time Warner[249]

1. Policy Disclosure

The Report contains a thorough discussion of the company's "Compensation Philosophy." The Committee significantly increased the ratio of equity to cash in the executives' compensation package in an effort to link compensation to improvements in "financial and operational performance reflected in stock-price performance." Executive compensation is targeted to be in the upper quartile of a pool of competitors larger than its traditional peer group index.

2. Performance Disclosure—Executive Officers

There is no discussion, of any kind, regarding the "specific relationship of corporate performance to executive compensation."[250] The Committee shirks this discussion in the portion of the Report where it separately discusses the Named Executive Officers and the CEO by stating that "all of the 2002 performance-based compensation [stock options] for these executive officers is solely dependent on future stock performance, not on other qualitative and quantitative performance measures."[251] This simply cannot be true. Stock performance is only one part of the equation which yields the final measure of the executives' compensation.

The other part of the equation is number of shares exercisable by those officers. While no mention is made to in the Report to these figures, they can be found in other parts

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performance" but does not "address how the size of the award was determined").

[249] AOL TIME WARNER INC., 2003 PROXY STATEMENT 17-19 (2003). Effective October 16, 2003, AOL Time Warner Inc. changed its name to Time Warner Inc. Consequently, at the time of the 2003 and 2002 Reports, AOL Time Warner Inc. was the name of the company.

[250] 17 C.F.R. § 229.402(k)(1) (2004).

[251] AOL TIME WARNER, INC., *supra* note 249, at 18.

of the Proxy Statement—Named Executive Officers each received options covering between 2,000,000 and 4,000,000 shares. The Committee, however, does not discuss the "specific relationship" between its company's performance and these stock option awards. Surely, the Committee did not draw numbers between 2,000,000 and 4,000,000 from a hat and assign them to an executive officer. If no relationship exists between the corporate performance and executive compensation, the Committee must state as much.[252]

3. Performance Disclosure—CEO

The Committee's discussion of the CEO is lumped in with its discussion of the Named Executive Officers. In the same sentence applicable to the named executive officers' stock options award (discussed above), the Committee sidesteps a specific discussion of the relationship of corporate performance to CEO compensation by stating that "all of the 2002 performance-based compensation for these executive officers [including the CEO] is solely dependent on future stock performance. . . ."[253]

Moreover, the Committee fails to discuss "each measure of the registrant's performance, whether qualitative or quantitative, on which the CEO's compensation was based."[254] Again, the Committee asserts there are none: "all of the 2002 performance-based compensation for these executive officers [including the CEO] is solely dependent on future stock performance, not on other qualitative and quantitative performance measures."[255] However, as with the

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[252] Adopting Release, *supra* note 29, at 48,138 ("[T]he report requires . . . the Committee's discussion of the relationship, if any, between corporate performance and executive compensation."). *See also* Guidance, *supra* note 42, at 42889 (negatively citing Reports that discuss a long-term compensation philosophy without addressing how the size of awards are determined).

[253] AOL TIME WARNER, INC., *supra* note 249, at 18.

[254] 17 C.F.R. § 229.402(k)(2) (2004).

[255] AOL TIME WARNER INC., *supra* note 249, at 18.

named executive officers' grant, the Committee does not discuss how it determined the number of shares it awarded.

4. Other CEO Factors and Criteria

The Committee discusses no Other CEO Factors and Criteria. The SEC rules do not "excuse general non-disclosure of the factors and criteria on which compensation was based, citing only unspecific performance or strategic goals. Such reports [are] uninformative."[256]

5. As compared to 2002[257]

The 2003 and 2002 Reports are substantially similar. Most of the stock option grants covering fiscal 2002 were made in fiscal 2001, with essentially the same disclosures.

6. As compared to 2004[258]

The 2004 Report completely overhauls the 2003 Report. The Committee incorporates more headings and bullet points, which makes the information more accessible. The Committee's discussion of the "2003 Accomplishments" thoroughly identifies how the various aspects of the bonus plan formula are weighted and the corporate performance measures that are considered. However, the Committee does not discuss how much it actually compensated the executives and how that compensation relates to corporate performance.

Moreover, the Committee attributes the CEO's annual bonus to, among other things, the "Company's performance described above. . . ." This reference clearly fails to communicate "each measure of corporate performance, whether qualitative or quantitative, on which the CEO's compensation was based."[259] Accordingly, the 2004 Report

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[256] Guidance, *supra* note 48, at 42,889.

[257] AOL TIME WARNER INC., 2002 PROXY STATEMENT 15-17 (Mar. 26, 2002).

[258] TIME WARNER INC., 2004 PROXY STATEMENT 22-27 (Apr. 1, 2004).

[259] 17 C.F.R. § 229.402(k)(2) (2004).

does not sufficiently discuss CEO compensation "for which more individualized disclosure is required by the rule."[260]

K. Results

As made plain by the Reports discussed above, Committees are still far from complying with the Report rules. With the exception of Policy Disclosure, the Report's intended purposes are not being fulfilled. The very same criticisms the SEC expressed over a decade ago[261] are equally warranted today. Overwhelmingly, Committees have shied away from discussing the "specific relationship of corporate performance to executive compensation."[262] Neither do Reports provide adequate disclosure of CEO compensation, "for which more individualized disclosure is required by the rule."[263]

In fairness to the companies, however, the above Reports also make plain that the SEC's rules and Guidance are not very clear. The Reports discussed above consistently and universally fail to fulfill the SEC's requirements. This is no recent phenomenon, though. Committees have systematically failed to meet Report requirements since the mid-1990s.[264] If the Reports are ever going to be the executive compensation analogue to the MD&A that they

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[260] Guidance, *supra* note 48, at 42,889.

[261] *See* Guidance, *supra* note 48.

[262] 17 C.F.R. § 229.402(k) (2004).

[263] Guidance, *supra* note 48, at 42,888.

[264] As noted elsewhere,

> [t]he trend in 1994 and to prepare thoughtful, creative and interesting compensation committee reports appears to have been interrupted. In fact, it is fair to say that the concern the Commission had in 1993, that certain reports in 1993 were perfunctory, seems to have come to pass. It is not that each of the included [2000 and 2001] compensation committee reports is the same as all the others, rather they are not very useful in indicating how the issuer views compensation on a year-to-year basis.

GUIDE TO COMPENSATION COMMITTEE REPORTS, *supra* note 54, at 4-3 - 4-4.

were intended to be,[265] the SEC must provide clarity and direction.

To that end, the SEC must revise its Guidance. As discussed throughout this Article, the SEC's use of terminology and application of the rules is often confusing. "Factors and criteria" are discussed in connection with executives and policies. Examples positively cited for one attribute are lacking another. The Guidance is organized by the headings of "Format," "Specificity," "Size of Pay Packages," and "Criteria for Awards." Many of the SECs' comments and examples under these headings fail to distinguish among policies, executives, and CEOs.

The "Compensation Committee Report Guide" (attached to this Article as Appendix A) is an attempt to clarify what is required under the Report rules. The "Compensation Committee Report Guide" is intended to provide a road map for Committees that will assist Committees in complying with the Report rules while, at the same time, allowing them to tell their own story in their own particular way.[266]

VI. CONCLUSION

Companies have been required to include Reports in their proxy statements for over a decade now. Aside from the couple of years following the issuance of the SEC's Guidance, companies have consistently and universally failed to live up to either the letter or the spirit of the Report's requirements. Recent corporate scandals have brought all aspects of corporate governance, including executive compensation, to the fore. While the SEC staff has undoubtedly issued companies post-Guidance comments on their Reports over the past 11 years, a more coordinated effort is clearly

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[265] Adopting Release, *supra* at note 29, at 29,594 n.44.

[266] The SEC crafted the Report rules with the intent to "allow each Compensation Committee to tell its particular story in its own way. The generality of the requirement is intended to accommodate the variety of compensation policies and practices and measures of company performance used by reporting companies." Guidance, *supra* note 48, at 42,887.

required. Now is the time for the SEC to revisit its Guidance and to provide all companies with the clarity and direction needed to make their Reports the analogue to the MD&A they were created to be.

APPENDIX A: COMPENSATION COMMITTEE REPORT GUIDE[267]

A. Policy Disclosure

The Committee must discuss its compensation policies applicable to all of the Company's executive officers. If policies for the "named executive officers" (the four mostly highly compensated officers other than the CEO) differ, specifically state as much and separately discuss those policies.[268]

The Committee should discuss its overall approach to executive compensation. Policy Disclosure will typically contain a discussion of the various components that comprise the total executive compensation package (e.g., salary, cash bonus, stock options, etc.). To the extent that each component serves a different purpose, the Committee should separately discuss each component's aim. For example, the Committee should identify and discuss those components that are purely intended to reward executives for last year's corporate performance and those components that are additionally intended to serve as a future incentive.

Because the Performance Disclosures below requires the Committee to disclose the extent to which, if any, compensation for the last year is related to corporate performance, the Committee should be sure to emphasize those aspects of its policies that relate to corporate performance measures.

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[267] This Compensation Committee Report Guide is intended to be a general resource for Committees to consult when creating Reports. For a detailed discussion of the SEC rules and the SEC Guidance relating to particular factual scenarios, see *supra* Parts II, III, and IV.

[268] A separate discussion relating to named executive officers is not required by the Report's rules. However, such a discussion gives investors a better understanding of the information regarding named executive officers that Item 402 requires companies to disclose elsewhere in their proxy statements.

B. Performance Disclosure—Executive Officers

The Committee must discuss the specific relationship of corporate performance to executive compensation for the last completed fiscal year. If the two are not related, the Committee must specifically state as much. If the specific relationship of corporate performance to the Named Executive Officers compensation differs from that of the rest of the executive officers, specifically state as much and separately discuss the relationship of the named executive officers' compensation (as a group) to corporate performance.[269]

Corporate performance may be discussed in the aggregate with reference to corporate performance measures such as sales; earnings; return on assets; return on equity; or market share. Discussions of an executive's individual performance (e.g., leadership, judgment, etc.) are not necessary. Executive Officer Performance Disclosure should be made on a component-by-component basis regarding the various aspects of executive compensation (e.g., cash bonus, stock options, etc.).

If the terms of an award subject it to some future event (e.g., passage of time or increase in share price), the Committee must 1) discuss those terms, and 2) discuss how the size of the award was actually made (e.g., the number of shares underlying a stock option award) was determined. In connection with the second prong, the Committee must discuss the specific relationship of the award to corporate performance. If no such relationship exists, the Committee must disclose as much.

Just saying that executive compensation was based on the corporate performance measures discussed is not enough. Shareholders can refer to the MD&A for an extensive discussion on corporate performance. Similarly, shareholders can find the amount of the named executive officers' compensation in other parts of the proxy statement. Executive Officer Performance Disclosure is intended to do

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[269] *See supra* text accompanying note 268.

more than just house two pieces of already-accessible information. The heart of this requirement is the Committee's discussion of how the two pieces of information—executive compensation and corporate performance—are related. Committees that do not explore this relationship with respect to any aspect of executive compensation must specifically state that executive compensation is not related to corporate performance with respect to that component.

C. Performance Disclosure—CEO

The Committee must specifically discuss the relationship of corporate performance to the CEO's compensation for last completed fiscal year. If the two are not related, the Committee must specifically state as much. CEO Performance Disclosure should be made on a component-by-component basis with respect to the various aspects of the CEO's compensation (e.g., cash bonus, stock options, etc.).

As opposed to Executive Officer Performance Disclosure, CEO Performance Disclosure requires the Committee to discuss all of the corporate performance measures—not just the quantitative measures—upon which the Committee relied. Accordingly, if the Committee partially based its decision on a more qualitative corporate performance measure, such as strengthened brand recognition, the Committee must disclose as much.

If the terms of an award subject it to some future event (e.g., passage of time or increase in share price), the Committee must 1) discuss those terms, and 2) discuss how the size of the award was actually made (e.g., the number of shares underlying a stock option award) was determined. In connection with the second prong, the Committee must discuss the specific relationship of the award to corporate performance. If no such relationship exists, the Committee must disclose as much.

As with Executive Officer Performance Disclosure, the pivotal discussion is the one that relates compensation to corporate performance. Just reciting two pieces of information already-accessible information—1) corporate performance, and 2) the CEO's compensation—is not sufficient. The crux of the requirement, and the medium through which shareholders are brought into the Committee meeting room, is the Committee's discussion of the extent to which the corporate performance is related to the CEO's compensation. It is of the utmost importance that this discussion not be glossed over. Committees that do not explore the relationship between corporate performance and the CEO's compensation, with respect to any aspect of the CEO's compensation, must specifically state that CEO compensation is not related to corporate performance with respect to that component.

D. Other CEO Factors and Criteria

Not only must the Committee disclose all of the corporate performance measures that influenced its CEO compensation decision, but it must also disclose the entire bases—that is, all of the "factors and criteria"—for its CEO compensation decision. Accordingly, personal attributes such as leadership, integrity, and loyalty, if considered, must be disclosed. Additionally, things like many years of devoted service or customer service, if considered, must be disclosed.

E. Section 162(m) Deduction

The Committee must discuss its policy with respect to qualifying compensation paid to its executive officers regarding deductibility under I.R.C. Section 162(m).

F. Organization

The only organizational and formatting requirements are as follows:

the Report must be separately captioned; and

the Report must appear over the names of the Committee members.

APPENDIX B
WORD COUNT CHART