

# COMPLIANCE WEEK

A Weekly Newsletter On Corporate Governance, Risk And Compliance

## Making The New CD&A Count For Something

By Louis M. Thompson, Jr., *Compliance Week Columnist* — September 19, 2006



**Louis M. Thompson**  
*Columnist*

Securities and Exchange Commission Chairman Christopher Cox recently told members of the New York Financial Writers Association that their jobs would be a lot easier if regulators didn't make things so complicated in the first place. "That's why, at the SEC, we're mounting an all-out war on needless complexity," Cox reportedly said. "Saying what you mean, and saying it clearly, will be every bit as important for the government as it is for companies and mutual funds."

To wit, the SEC's new rule on executive compensation disclosure is designed to provide institutional and—even more importantly, individual—investors a clear understanding of top executives' total compensation and the company's compensation goals and objectives.

Unfortunately, the SEC's "tone at the top"—Cox's call for a war on complexity that would yield simplicity and clarity of SEC rules—apparently did not trickle down to those who crafted the 436-page regulation. Admittedly, the SEC staff's job was made more difficult by the varied and complex forms and components of top executive compensation—particularly when it comes to stock options, restricted stock, and similar grants. Page after page of the rule is devoted to a discussion of how transparency is to be achieved through the compensation tables.

I would not, nor does the SEC, suggest that executive compensation be standardized through regulation; perhaps, however, once the complexity of compensation is laid out in tabular form, transparency may cause investors to urge companies to simplify equity-based compensation.

A key component of the rule is the new Compensation Discussion and Analysis section. This will be "filed," not "furnished," as part of disclosure that is subject to certification by a company's principal executive and financial officers. The CD&A, which is at the heart of the rule, is designed to make clear to investors what the material factors are that underlie the compensation policies and decisions reflected in the data presented in the compensation tables.

The CD&A will begin with a compensation policy overview that is similar to the type of disclosure the Commission advocates in the Management's Discussion & Analysis section of companies' periodic reports. Unfortunately, many companies do not present an MD&A overview, claiming that they may be liable for errors of omission should they inadvertently omit material information from their overview, even though it is contained elsewhere in the body of the document.

In the new compensation disclosure rule, companies must provide a CD&A overview.

The CD&A presents companies with an opportunity to explain to investors in plain English what their compensation policies and goals are in awarding the total compensation packages for key executives. These goals should flow from the company's strategy, so it is critical that companies have clearly articulated strategies that investors not only understand, but believe that management has the wherewithal to accomplish. In survey after survey of key factors institutional investors consider when making investment decisions, having a "clear and credible compensation strategy" ranks right at the top, second only to "quality of management." By the way, these factors far outweigh earnings per share when institutional investors make investment decisions.

Companies generally do an adequate job of articulating their strategies in investor conferences and one-on-one investor meetings. Some, however, may flinch when it comes to discussing their strategy in a filed document. Why? Too often, I hear companies say that communicating what drives value in their own company gives competitors too much information. Competitive intelligence is often an excuse to avoid disclosure, forcing investors to focus on more short-term performance factors such as quarterly earnings per share.

The reality in today's information environment is that peers within an industry group know a great deal about each other. The Internet has become a treasure trove of information; investors listen in on peers' quarterly conference calls; analysts sometimes share information with companies they cover about their peer companies. Academics who have studied this phenomenon conclude that the concern over competitive intelligence—beyond trade secrets and other confidential information—is often overblown.

Yet, in crafting the instructions for preparing the CD&A, the SEC recognized that specific "pay-for-performance" targets—even on an after-the-fact basis—could pose significant risk of competitive harm. Therefore, the rule does not require it where the factors or criteria considered in creating performance targets involve trade secrets or other confidential information that might result in competitive harm to the company. Hopefully, companies will not use this as an excuse to avoid disclosure of performance targets that are based on largely publicly available information.

I recently participated in a series of symposia on "Breaking the Short-Term Cycle," sponsored by the CFA Center for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics. One of the primary recommendations in our June 2006 report calls for aligning corporate executive compensation with long-term shareowner interests by structuring compensation to achieve long-term strategic and value-creation goals.

The report also recommends that stock ownership guidelines should require all executives and directors to hold a "meaningful" amount of equity in their company, defined as an amount that makes it economically material to the individual that the company succeeds in the long-term.

Long-term goals can be expressed in a variety of ways. Among them are:

- effectively communicating the company's strategy (which can be measured by surveying the company's institutional shareholders);
- providing financial results that increase shareholder value over a specified period (which can be expressed as a target for relative ranking among the company's peers, based on total shareholder return or targeted increases in annualized discounted cash flow);

- using research and development to enhance the company's long-term productivity (an area often cut to meet financial analysts' short-term earnings projections);
- achieving productivity goals based on effective use of the company's human capital; and
- achieving a targeted ranking among peers based on relevant customer satisfaction indices.

If those who can communicate in plain English are involved in crafting the CD&A, investors may have an opportunity to really understand what underlies compensation goals for key executives. This should drive how company officials discuss corporate performance when meeting with investors. Therefore, it's imperative that the communicators put their stake in the ground and play a key role in preparing the "discussion" component of the CD&A, before lawyers and controllers take over the entire process and the CD&A becomes another MD&A.

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### **About The Author**

Louis Thompson Jr. is an internationally recognized expert on corporate governance and disclosure, having served for more than two decades as president and chief executive officer of the National Investor Relations Institute until his retirement earlier this year. An adviser to the Securities and Exchange Commission and the New York Stock Exchange, Thompson is currently serving a second term on the NYSE Individual Investor Advisory Committee.

Prior to joining NIRI, Thompson was assistant White House press secretary to President Gerald Ford.

A veteran of the U.S. Command in Vietnam and the Office of the Secretary of Defense, Thompson has held executive communications positions for a number of organizations, including the American Enterprise Institute for Public Policy Research, and the National Council for Economic Education.

A former journalist and news anchor, Thompson remains chairman of the advisory council for the Greenlee School of Journalism and Communication at Iowa State University, where he was the 2001 recipient of the James W. Schwartz Award for Distinguished Service in Journalism and Communication conferred by the Greenlee School.

A former member of the Harvard University New Foundations Working Group on corporate governance, Thompson is a partner with business consultancy Genesis, based in Denver. He is also a managing director of Washington, D.C.-based Kalorama Partners, the advisory firm founded by former SEC Chairman and Compliance Week Columnist Harvey Pitt.

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[SEC Relents In Final Comp Rule; Clarity On Options, CD&A](#) (Aug. 15, 2006)

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