Director Notes

The 2010 Proxy Season

Enhanced Disclosure in the Dow 30 and Select Financial Companies

Compensation-Related Risk and Compensation Consultants

by Edmond T. FitzGerald, Bernice A. Grant, Jennifer L. Freiman, Jamila A. Diggs, and Jessica Lutrin

The analysis of disclosure included in 2010 proxy statements by some of the largest U.S. public companies shows that all surveyed financial companies and as many as 77 percent of the other survey participants made an affirmative statement with respect to the correlation between compensation granted to their executives and the executives' risk behavior. In qualifying such risk, about 60 percent of financial companies and 53 percent of non-financial companies referred to the likelihood of a material adverse effect on the company's business. To mitigate the risk, companies use an array of measures, including clawbacks and stock-holding guidelines. Virtually all surveyed companies retain compensation consultants, with disclosed fees ranging from $100,000 to $440,000; however, fees paid to the consultants for additional services range from $2.4 million to $4.9 million.

As part of its efforts to address the perception that executive compensation practices were a significant factor in the recent financial crisis, the U.S. Securities and Exchange Commission recently promulgated Item 402(s) and Item 407(e)(3)(iii) of Regulation S-K. The former requires companies to discuss compensation policies and practices as they relate to risk management and risk-taking incentives to the extent that risks arising from such policies and practices are "reasonably likely to have a material adverse effect" on the company. Item 407(e)(3)(iii) requires companies to disclose fees paid to compensation consultants in their proxy statements, if "the compensation consultant or its affiliates also provided additional services to the [company] or its affiliates in an amount in excess of $120,000."[1] New provisions on these matters are also included in the newly enacted Wall Street Reform and Consumer Protection Act of 2009.[2] (See "Compensation Provisions in the New Financial Reform" on p. 10.)

THE CONFERENCE BOARD
Trusted Insights for Business Worldwide

This *Director Notes* is the fourth in a series of studies developed in collaboration with Davis Polk & Wardwell LLP to provide guidelines and examples to member companies of The Conference Board on emerging disclosure practices following the SEC enhanced disclosure reform of December 2009. It is based on the analysis of 2010 proxy statements of the 22 non-bank companies in the Dow 30 that were subject to the new rules in 2010, plus the five large U.S. banks (Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase and Morgan Stanley) (see box below.) Though actual disclosure practices diverged significantly across companies, several important observations are offered here. The results for banks are presented separately, recognizing that their approach to this disclosure may be different due to their business models and/or regulatory oversight responsibilities.

The Survey

Findings discussed in this report are based on the analysis of 2010 proxy statements filed with the U.S. Securities and Exchange Commission by corporations in the Dow Jones Industrial Average, as well as those of select financial institutions.

Dow 30 Companies

3M Company
Intel Corporation
Alcoa Inc.
International Business Machines Corporation
American Express Company
Johnson & Johnson
AT&T Inc.
JPMorgan Chase & Co.
Bank of America Corporation
Kraft Foods, Inc.
The Boeing Company
McDonald's Corporation
Caterpillar Inc.
Merck & Co., Inc
Chevron Corporation
Microsoft Corporation[a]
Cisco Systems, Inc.[a]
Pfizer Inc.
The Coca-Cola Company
The Procter & Gamble Company[a]
E.I. du Pont de Nemours and Company
The Travelers Companies, Inc.
Exxon Mobil Corporation
United Technologies Corporation[a]
General Electric Company
Verizon Communications Inc.
Wal-Mart Stores, Inc.
Hewlett-Packard Company[a]
The Walt Disney Company[a]
The Home Depot, Inc.

Select Financial Institutions

Bank of America Corporation[b]
Citigroup Inc.
The Goldman Sachs Group, Inc.
JPMorgan Chase & Co.[b]
Morgan Stanley

a These companies (collectively the "Early Filers") filed their proxy statement before the effective date of the new Regulation S-K rules or have fiscal year-ends before December 20, 2009. As a result, they are largely excluded from the Survey results.

b Bank of America and JPMorgan Chase are also in the Dow 30.

Compensation-Related Risk Disclosure

Item 402(s) of Regulation S-K provides as follows:

Narrative disclosure of the company's compensation policies and practices as they relate to the company's risk management.

To the extent that risks arising from the company's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the company, discuss the company's policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives.

While the situations requiring disclosure vary depending on the particular company and compensation policies and practices, they do include, among others, compensation policies and practices:

- at a business unit of the company that carries a significant portion of the company's risk profile;
- at a business unit with compensation structured significantly differently than other units within the company;
- at a business unit that is significantly more profitable than others within the company;
- at a business unit where compensation expense is a significant percentage of the unit's revenues; and
- that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

The purpose of the disclosure is to provide investors material information concerning how the company compensates and incentivizes its employees that may create risks that are reasonably likely to have a material adverse effect on the company. While the information to be disclosed depends upon the nature of the company's business and the compensation approach, the following are examples of the issues that the company may need to address for the business units or employees discussed:

1. The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk-taking by employees on behalf of the company, and the manner of their implementation.
2. The company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation.
3. How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring clawbacks or imposing holding periods.
4. The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile.
5. Material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile.
6. The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

Affirmative statements on compensation-related risk

For purposes of the survey, a company made an affirmative statement if, after reviewing its compensation policies and practices, it concluded and disclosed that its policies and practices do not encourage excessive and unnecessary risk-taking, or that its policies and practices are not reasonably likely to have a material adverse effect on the company.[3]

Disclosure analysis on non-financial companies[4] showed:

- As many as 17 of the surveyed non-financial companies (77 percent) made an affirmative statement regarding risk.
- The remaining five non-financial companies (23 percent) did not make an affirmative statement, but provided analysis as to whether their compensation programs and policies encourage unnecessary and excessive risk-taking.

Out of the five financial companies considered in the survey, all five made an affirmative statement regarding compensation-related risk.

Chart 1

Non-Financial Companies – Affirmative Statements on Compensation-Related Risk

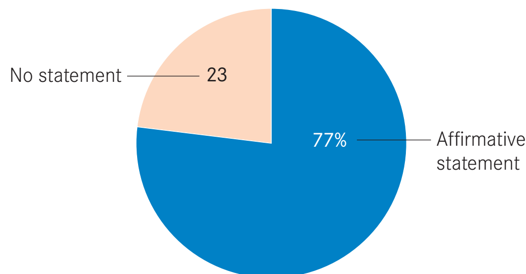


Chart 2

Financial Companies – Affirmative Statements on Compensation-Related Risk

Material adverse effect Of the 17 non-financial companies that made an affirmative statement regarding risk:

- As many as nine companies (53 percent) referred to the likelihood of a "material adverse effect" in their affirmative statement on compensation-related risks.
- Eight companies (47 percent) did not use the language "material adverse effect" in their affirmative statement.

Among the five surveyed financial companies:

- Three companies (60 percent) used the language "material adverse effect" in their affirmative statement.
- Two companies (40 percent) did not use the language "material adverse effect" in their affirmative statement.

Chart 3

Non-Financial Companies – Material Adverse Effect

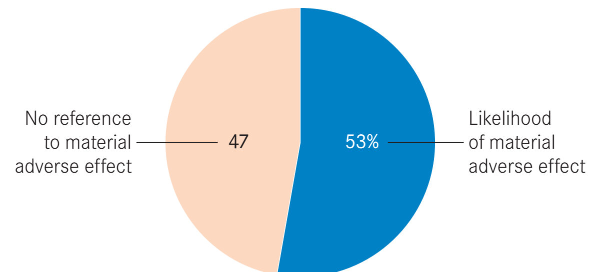
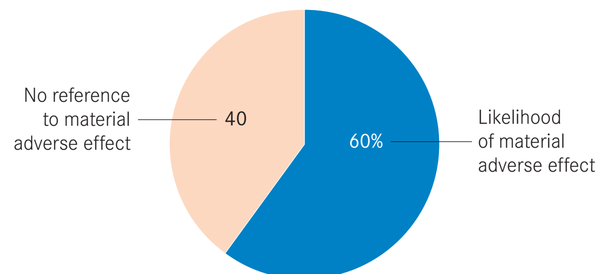


Chart 4

Financial Companies – Material Adverse Effect



Placement of disclosure Of the 17 non-financial companies that made an affirmative statement regarding compensation-related risk:

- Six companies (35 percent) made the disclosure in the Compensation Discussion and Analysis (CD&A) section only, even though the disclosure is not required to be included within the CD&A.
- Six companies (35 percent) made the disclosure in the Board Oversight section, with analysis of their compensation structures included in the CD&A.
- Three companies (18 percent) made the disclosure in an independent section within the proxy.
- One company (6 percent) made the disclosure in a response to a shareholder proposal.
- One company (6 percent) made the disclosure in the Board Oversight section only.

With respect to the five surveyed financial companies:

- Two companies (40 percent) made the disclosure in the CD&A only.
- Two companies (40 percent) made the disclosure in the Board Oversight section, with analysis of their compensation structures included in the CD&A.
- One company (20 percent) made the disclosure in the Board Oversight section only.

Chart 5
Non-Financial Companies – Placement of Disclosure

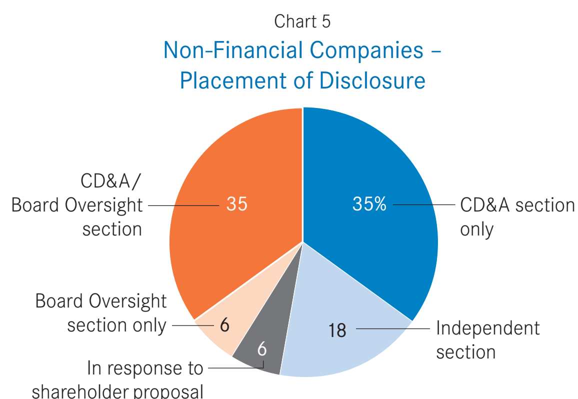
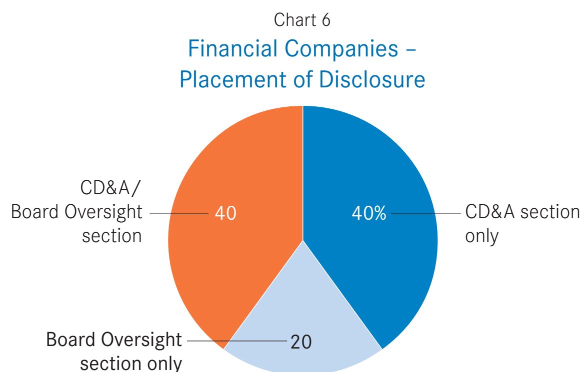


Chart 6
Financial Companies – Placement of Disclosure



Mitigation of risk Of the 22 surveyed non-financial companies, the following indicated that they use the specified measure in order to mitigate compensation-related risk:

- Ten companies cited a clawback policy.[5]
- Eight companies cited delayed vesting/holding periods for equity awards.[6]
- As many as 16 companies cited a minimum required stock ownership requirement.[7]

However, of the five surveyed financial companies:

- All five companies cited a clawback policy.[8]
- Two companies cited delayed vesting/holding periods for equity awards.[9]
- Three companies cited a minimum required stock ownership requirement.[10]

Chart 7
Non-Financial Companies – Mitigation of Risk

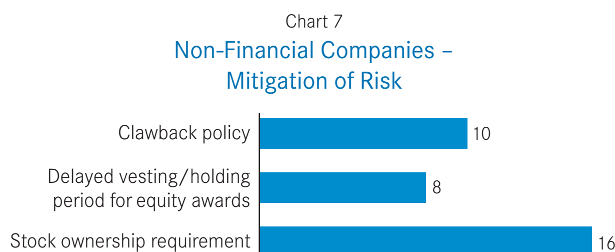
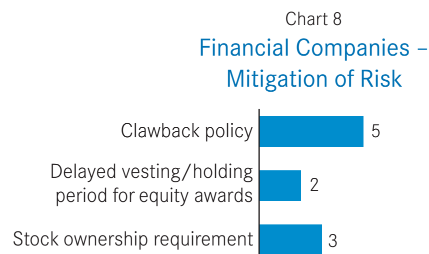


Chart 8
Financial Companies – Mitigation of Risk



Other Interesting Findings[a]

Nature of Affirmative Statements

As many as 55 percent of companies that made an affirmative statement regarding compensation-related risk specifically indicated that their compensation structures do not create risks that are reasonably likely to have a material adverse effect on the company.

The remaining 45 percent of companies that made an affirmative statement regarding compensation-related risk stated that their compensation plans do not encourage executives to take unnecessary and excessive risks, without any material adverse effect qualifier.

Evaluating Compensation-Related Risk

All but one company that made an affirmative statement provided an explanation as to how they evaluated their compensation structures.

The following processes, among others, were used by companies to evaluate compensation-related risk:

- Engaging independent compensation consultants to review the company's compensation structure to determine whether it encourages risky behavior.
- Engaging the audit committee and/or chief risk officer to assist the compensation committee in its review process.
- Using full board oversight, rather than just a committee, when evaluating risk.

[a] Early Filers were excluded from the analysis of "Interesting Findings."

Location of Disclosure

Even if compensation-related risk was addressed elsewhere in the proxy, the bulk of the information was typically placed in the CD&A and the analysis usually occupied between a half page and a full page.

Mitigation of Risks

All but one of the surveyed companies discussed how they mitigate risks inherent in their compensation policies/practices. Common mitigating tools listed in this context include:

- Clawback provisions.
- Stock holding guidelines.
- Vesting/holding periods for equity grants.
- A mix of short-term and long-term compensation, with an emphasis on long-term compensation.
- The use of a variety of performance metrics to determine compensation.
- A discretionary (rather than formulaic) approach to determining compensation.
- Fixed maximum awards for NEOs.
- Performance evaluations of executives over extended time periods.
- The existence of strong ethics and corporate compliance systems.
- Eliminating payout "cliffs" that might lead to risky behavior.

Compensation Consultant Disclosure

Item 407(e)(3)(iii) of Regulation S-K provides as follows:

(A) If a compensation consultant was engaged by the compensation committee (or persons performing the equivalent functions) to provide advice or recommendations on the amount or form of executive and director compensation (other than any role limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the company, and that is available generally to all salaried employees; or providing information that either is not customized for a particular company or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) *and the compensation consultant or its affiliates also provided additional services to the company or its affiliates in an amount in excess of $120,000 during the company's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for such additional services*. Disclose whether the decision to engage the compensation consultant or its affiliates for these other services was made, or recommended, by management, and whether the compensation committee or the board approved such other services of the compensation consultant or its affiliates.

(B) If the compensation committee (or persons performing the equivalent functions) has not engaged a compensation consultant, but management has engaged a compensation consultant to provide advice or recommendations on the amount or form of executive and director compensation (other than any role limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the company, and that is available generally to all salaried employees; or providing information that either is not customized for a particular company or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) *and such compensation consultant or its affiliates has provided additional services to the company in an amount in excess of $120,000 during the company's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the compensation consultant or its affiliates*.

Compensation consultants retained Of the 22 non-financial companies subject to Item 407(e):

- As many as 21 companies (95 percent) identified the executive compensation consultant by name.
- One company (5 percent) did not retain a compensation consultant.

Among the five surveyed financial companies:

- Four companies (80 percent) identified their executive compensation consultant by name (each of the four identified a different compensation consulting firm).
- One company (20 percent) did not retain a compensation consultant but utilized external sources to provide certain compensation data.

Chart 9

Non-Financial Companies – Compensation Consultants Retained

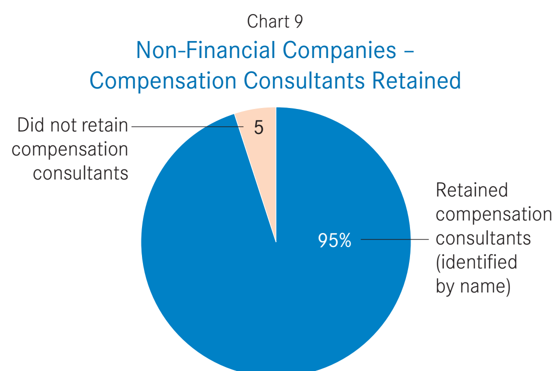
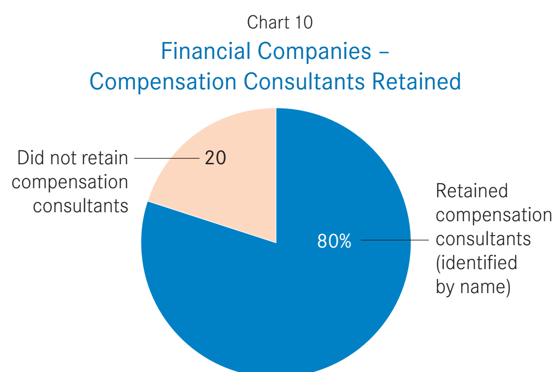


Chart 10

Financial Companies – Compensation Consultants Retained



Compensation consultant fees Of the 21 non-financial companies that retained a compensation consultant:

- Eight companies (38 percent) disclosed their fees.
- As many as 13 companies (62 percent) did not disclose their fees.

Of the five surveyed financial companies:

- One company (20 percent) disclosed its fees.
- Four companies (80 percent) did not disclose their fees.

Chart 11
Non-Financial Companies – Compensation Consultant Fees

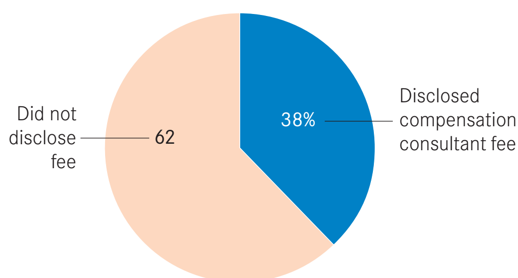
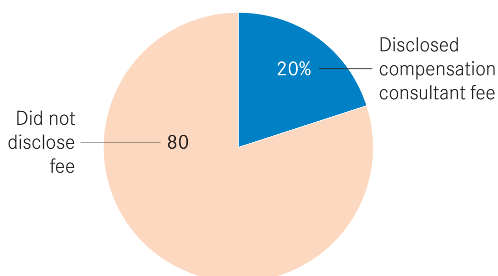


Chart 12
Financial Companies – Compensation Consultant Fees



Retaining committees (other than the compensation committee) Of the 21 non-financial companies that retained a compensation consultant, nine had committees other than the compensation committee that retained a compensation consultant. Specifically, the following committees retained one or more compensation consultants:

- Six corporate governance committees.
- One board affairs committee.
- Two other committees, such as the audit committee.

None of the surveyed financial companies reported situations where compensation consultants were retained by a committee other than the compensation committee.

Additional services Of the 21 non-financial companies that retained compensation consultants, a number reported that they received additional services from such consultants. In particular:

- Three provided other consulting services.
- Two provided financial services, including actuarial services.
- Four provided human resources services, including general employee services.
- Three provided other services, such as IT support.

Chart 13
Non-Financial Companies – Retaining Committees (Other than Compensation Committee)

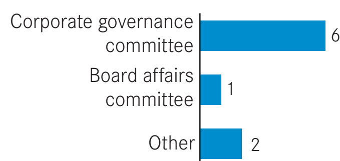
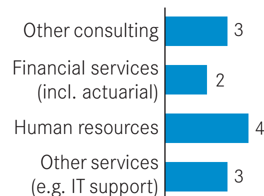


Chart 14
Non-Financial Companies – Additional Services



Other Interesting Findings[a]

Disclosed Fees Paid to Compensation Consultants

Fees paid to the consultants for compensation-related services ranged from approximately $100,000 to $440,000. Fees paid to the consultants for additional services ranged from approximately $2.4 million to $4.9 million, with one outlier at approximately $14.9 million. Very few companies voluntarily disclosed the fees paid to their compensation consultant when not required to do so pursuant to Item 407(e)(3)(iii).

Independence of Compensation Consultants

None of the financial companies discussed the independence of their compensation consultant,[b] compared to 43 percent of non-financial companies who did. In assessing independence, non-financial companies either:

- performed annual reviews of their consultant's independence, or
- established an independence policy or guidelines to evaluate independence.

The following factors, among others, were used to assess independence:

- whether the compensation committee has authority to hire and terminate the consultant;
- whether there are limitations on the amount of fees paid to the consultant or its affiliates;
- whether the consultant provided a certificate of compliance with the company's independence policy or guidelines;
- whether the consultant provided additional services to the company or management; and
- whether executive compensation services were separated from other services performed by the consultant.

---

a Early Filers were excluded from the analysis of "Interesting Findings."

b Some consulting firms have recently separated or spun off their executive compensation services into a single, segregated business unit. In the future, there may be increased disclosure of the processes by which the independence of compensation consultants is assessed.

Compensation Provisions in the New Financial Reform

New provisions on compensation-related risk disclosure and the independence of compensation consultants are also included in The Wall Street Reform and Consumer Protection Act of 2009 (also known as Dodd-Frank Act.)

Pay for performance disclosure Amended Section 14 of the Exchange Act directs the SEC to adopt rules requiring public companies to include in the compensation section of their annual meeting proxy statement information detailing the relationship between executive compensation actually paid and the company's financial performance, taking into account any change in stock value, dividends and any other distributions. The information may include a graph representation of the relationship.

Compensation consultants New Section 10C of the Exchange Act gives compensation committees the authority to hire compensation consultants, legal counsel and other advisers. It also imposes on compensation committees direct responsibility for the appointment, compensation and the oversight of these advisers, and provides that companies must provide appropriate funding, as determined by the compensation committee, to compensate advisers.

Under the Act, compensation committees may only select compensation consultants, legal counsel and other advisers after taking into account factors that the SEC will identify as potentially affecting their independence, including:

i. the provision of other services to the company;
ii. the amount of fees received from the company as a percentage of the adviser's revenues;
iii. the company's policies or procedures designed to prevent a conflict of interest;
iv. the existence of a business or personal relationship between the adviser and a member of the compensation committee; and
v. whether the adviser owns stock of the company.

Finally, companies are required to disclose in their proxy statement whether the compensation committee retained or obtained advice from a compensation consultant and whether such work caused a conflict of interest (including, if so, the nature of the conflict and how it was addressed).

Source: Pub.L. 111-203, H.R. 4173, which, among other things, amends Section 14 and introduces new Section 10C of the Securities Exchange Act of 1934.

Endnotes

1 Regulation S-K, Item 402(s) and 407(e)(3)(iii). Also see SEC Release No. 33-9089; 34-61175 (“Proxy Disclosure Enhancements”), December 16, 2009, available at ww.sec.gov/rules/final/2009/33-9089.pdf. The rules apply to proxy and information statements, annual reports and registration statements under the Exchange Act, and registration statements under the Securities Act as well as the Investment Company Act. They do not apply to foreign private issuers. For an extensive discussion of the practical implications of the reform, see William M. Kelly and Mutya Fonte Harsch, “Directors’ Duties Under the New SEC Rules on Disclosure Enhancement,” Director Notes No. DN-005, February 2010.

2 Pub.L. 111-203, H.R. 4173.

3 Although the Early Filers were not subject to Item 402(s) for the 2010 proxy season, two Early Filers made an affirmative statement regarding compensation-related risk while four Early Filers merely analyzed how their compensation structures work to mitigate risk, but did not make an affirmative statement.

4 “Non-Financial Companies” include the 22 non-bank companies in the Dow 30 that were subject to Item 402(s) in 2010.

5 Clawbacks are required pursuant to Section 304 of the Sarbanes-Oxley Act of 2002. As such, all 22 surveyed non-financial companies have a clawback policy in place, but only 10 of them listed it as a risk-mitigating factor. In addition, some of those companies implemented clawbacks that exceed the Sarbanes-Oxley requirement.

6 All 22 surveyed non-financial companies have delayed vesting/holding periods for equity awards, but only eight of them listed it as a risk-mitigating factor.

7 All 22 surveyed non-financial companies have a minimum required stock ownership requirement, but only 16 of them listed it as a risk-mitigating factor.

8 All five surveyed financial companies have a clawback policy in place. In addition, some of them implemented clawbacks that exceed the Sarbanes-Oxley requirement.

9 All five surveyed financial companies have delayed vesting/holding periods for equity awards, but only two of them listed it as a risk-mitigating factor.

10 All five surveyed financial companies have a minimum required stock ownership requirement, but only three of them listed it as a risk-mitigating factor.

About the Authors

Edmond T. FitzGerald is a member of Davis Polk's executive compensation and employee benefits practice group. He works closely with the firm's corporate department on matters involving executive compensation and employee benefits, both in the ordinary course of clients' business and in the context of mergers and acquisitions, new ventures, and restructurings. He has substantial experience in structuring employment agreements, equity compensation, performance incentives, deferred compensation, change in control protections, and management participation in buyouts and new ventures. He is a graduate of Cornell University and Brooklyn Law School.

Bernice A. Grant is an associate in Davis Polk's Corporate Department, where her practice focuses on executive compensation and employee benefits. She is a graduate of Harvard Law School.

Jennifer L. Freiman is an associate in Davis Polk's Corporate Department, where her practice focuses on executive compensation and employee benefits. She holds a J.D. magna cum laude from Cornell Law School, where she served as an editor of the *Cornell Law Review*.

Jamila A. Diggs is an associate in Davis Polk's Corporate Department, where her practice focuses on executive compensation and employee benefits. She is a graduate of Georgetown University Law Center.

Jessica Lutrin is an associate in Davis Polk's Corporate Department, where her practice focuses on executive compensation and employee benefits. She is a graduate of the University of the Witwatersrand, Oliver Schreiner School of Law.

About the Series Director

Matteo Tonello is director, corporate governance research, at The Conference Board in New York. For The Conference Board, Tonello has conducted governance and risk management analyses and research in collaboration with leading corporations, institutional investors, and professional firms. Also, he has participated as a speaker and moderator in educational programs on governance best practices. Recently, Tonello served as the co-chair of The Conference Board's Expert Committee on Shareholder Activism and as a member of the Technical Advisory Group to The Conference Board Task Force on Executive Compensation. Before joining The Conference Board, he practiced corporate law at Davis Polk. Tonello is a graduate of Harvard Law School and the University of Bologna.

About Director Notes

Director Notes is a series of online publications in which The Conference Board engages experts from several disciplines of business leadership, including corporate governance, risk oversight, and sustainability, in an open dialogue about topical issues of concern to member companies. The opinions expressed in this report are those of the author(s) only and do not necessarily reflect the views of The Conference Board. The Conference Board makes no representation as to the accuracy and completeness of the content. This report is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.

About The Conference Board

The Conference Board is the world's preeminent business membership and research organization. Best known for the Consumer Confidence Index and the Leading Economic Indicators, The Conference Board has, for over 90 years, equipped the world's leading corporations with practical knowledge through issues-oriented research and senior executive peer-to-peer meetings.

The Conference Board
www.conferenceboard.org
Global Headquarters
845 Third Avenue
New York, NY 10022-6600
United States
Tel + 1 212 759 0900
Fax + 1 212 980 7014

Asia-Pacific
22/F, Shun Ho Tower
24-30 Ice House Street, Central
Hong Kong SAR
Tel + 852 2804 1000
Fax + 852 2869 1403

China
Beijing Representative Office
7-2-72 Qijiayuan, 9 Jianwai Street
Beijing 100600 P.R. China
Tel + 86 10 8532 4688
Fax + 86 10 8532 5332
www.conferenceboard.cn

Europe
Chaussée de La Hulpe 130, box 11
B-1000 Brussels, Belgium
Tel + 32 2 675 54 05
Fax + 32 2 675 03 95

South Asia
A-701 Mahalaxmi Heights
Keshavrao Khadye Marg
Mahalaxmi (East)
Mumbai 400 011 India
Tel + 91 22 23051402

Copyright © 2010 by The Conference Board, Inc. All rights reserved.
The Conference Board® and the torch logo are registered trademarks of The Conference Board, Inc.