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Update: Executive Compensation

As we have reported in past Updates, there has been increased focus by the SEC on the adequacy of disclosure concerning executive compensation. In late September 2004, the SEC used an enforcement action against General Electric to send a strong message to registrants and their advisers that the SEC Staff was concerned about, and would be focusing on, inadequate or incomplete disclosure of items of executive compensation. The SEC continued its enforcement activity in this area by bringing and settling an enforcement action against The Walt Disney Company in late December 2004 and settling an action against Tyson Foods and its former senior chairman in late April 2005. In a speech in late October 2004, the Director of the Division of Corporation Finance outlined certain of the issues surrounding executive compensation that the Staff is focusing on. These themes have since been reiterated in various public statements.

This memorandum updates our prior reports to add a summary of the settlement involving Tyson Foods and its former senior chairman.

Recent SEC Enforcement Actions

Tyson Foods, Inc.

In August 2004, Tyson Foods, Inc. announced it received notice the SEC Staff intended to recommend a civil enforcement action against Tyson and was considering seeking a monetary penalty. The notice alleged that Tyson's proxy statements filed with the SEC from 1997 through 2003 failed to comply with SEC regulations with respect to disclosure regarding perquisites provided to Don Tyson, former senior chairman of Tyson, totaling approximately $1.7 million and that Tyson failed to maintain an adequate system of internal controls regarding the personal use of company assets and the disclosure of perquisites and personal benefits. Don Tyson voluntarily repaid $1.5 million to Tyson for certain items identified by independent members of the Board of Directors.

In late April 2005, the SEC announced that both Tyson Foods and Don Tyson had settled enforcement proceedings against them, with the company agreeing to pay a $1.5 million fine and Don Tyson agreeing to pay a $700,000 fine.

Disclosure while Tyson was senior chairman. The SEC found that the company had provided Don Tyson with $3.0 million in personal expenses, use of company-owned homes, company-owned aircraft, housekeeping, lawn maintenance, automobile maintenance and gift certificates, as well as tax gross ups for the these items. Proxy statement disclosure of perquisites and personal benefits were made in footnotes to "other annual compensation" in the summary compensation table, describing these items as "travel and entertainment" when, in fact, they were neither. In various years, costs of personal expenses, use of company homes, use of aircraft and other services exceeded the 25% threshold for separate disclosure, but were not so disclosed.

The SEC found that the company's in-house counsel responsible for the proxy statement was unaware of certain perquisites and that Don Tyson had signed D&O questionnaires that only disclosed "travel and entertainment" costs. The SEC further found that Don Tyson had delegated responsibility for the accuracy of the questionnaires, had not read them before signing and took no other action to determine the accuracy of his responses.

Additional perquisites and the tax gross-up thereon were omitted from the proxy statement's disclosure of perquisites due to a strategy to permit the company to deduct Don Tyson's entire compensation, notwithstanding the limits of IRC Section 162(m). Don Tyson signed D&O questionnaires that incorrectly stated that he received bonuses rather than disclosing that these amounts were perquisites. The amounts were improperly disclosed as performance-based bonuses by moving them from the "other compensation" column (used for perquisites) to the "bonus" column. Other perquisites that were disclosed were characterized as "travel and entertainment."

The SEC found that due to internal control failures many of the perquisites were neither raised with nor authorized by the compensation committee or the full board. As a result, until the SEC investigation, board members were unaware that the company was paying for substantial personal expenses incurred by Don Tyson and two of his friends.

Disclosure upon following retirement. Upon retiring as senior chairman, Don Tyson and the company had entered into a retirement agreement, which was filed as an exhibit to a Form 10-K and, among other things, made reference to "travel and entertainment costs" and tax gross-up consistent with past practices. The proxy statement disclosed that Don Tyson would receive "travel and entertainment costs" but made no other disclosure describing the full nature and scope of the perquisites. As with the prior disclosure, the proxy statement failed to accurately characterize the nature of the perquisites. In addition, the disclosure reported only about half of the amounts Don Tyson actually received.

SEC findings. The SEC found that the company had violated Section 13(a) and Rule 13a-1 for filing proxy statements that failed to fully and accurately disclose the perquisites Don Tyson received while he was senior chairman and thereafter. The company also was found to have violated Section 13(b)(2)(B) for failing to devise and maintain proper internal accounting controls that would have prevented Don Tyson from receiving undisclosed perquisites as well as perquisites that had not been authorized by the compensation committee or the board, as a result of which the company failed to fully and accurately disclose the benefits and perquisites received. The misleading and incomplete disclosures also failed to comply with the requirements of S-K Item 402, thus resulting in a violation of Section 14(a) and Rules 14a-3 and 14a-9. Don Tyson was found to have aided and abetted the company's violations of Section 13(a) and Rules 13a-1 and Section 14(a) and Rule 14a-3 and 14a-9, citing among other things the fact that he signed the D&O questionnaires that disclosed receipt of "travel and entertainment" costs and signed the Forms 10-K that incorporated the proxy statements by reference without having read either the questionnaires or the proxy statement, and that he provided incomplete lists of perquisites in the questionnaires.

General Electric Company.

On September 23, 2004, the SEC announced that it instituted and settled enforcement proceedings against General Electric Company. The SEC found that from 1997 to 2002 GE failed to fully and accurately describe in proxy statements and annual reports the retirement benefits John F. "Jack" Welch, Jr., former chairman and CEO, was entitled to receive from GE. The SEC concluded that GE's inadequate disclosure violated Sections 13(a) and 14(a) of the Securities Exchange Act of 1934 and Rules 13a-1, 14a-3 and 14a-9 of the Exchange Act. GE settled the proceedings by consenting to the entry of an order by the SEC that it cease and desist from violating the proxy solicitation and periodic reporting provisions of the federal securities laws.

GE and Welch entered into an "employment and post-retirement consulting agreement" in 1996 which was filed as an exhibit to GE's 1996 Form 10-K and incorporated by reference as an exhibit in each subsequent Form 10-K until Welch retired in 2000. The Welch agreement disclosed that Welch would receive access to company facilities and services comparable to those provided to him prior to his retirement, including access to company aircraft, cars, office, apartments and financial planning services. GE's 1997 proxy statement referred to Welch's entitlement to ". . . continued lifetime access to Company facilities and services comparable to those that are currently made available to him by the Company." GE included this same disclosure in each of the subsequent five proxy statements it filed through 2002.

The SEC found that GE's disclosure did not provide investors with details of many of the most significant "facilities and services" Welch had been provided prior to his retirement, including personal use of GE-owned aircraft, personal use of chauffeured limousines and home security systems. The year following Welch's retirement, Welch received approximately $2.5 million, previously estimated by GE to be $1 million per year, in benefits under his retirement agreement, which included:

- access to GE aircraft for unlimited personal use and for business travel;
- exclusive use of a furnished New York City apartment that, according to GE, had a rental value of approximately $50,000 per month and a resale value in excess of $11 million;
- unrestricted access to a chauffeured limousine driven by professionals trained in security measures;
- a leased Mercedes Benz;
- office space in both New York City and Connecticut;
- the services of professional estate and tax advisors;
- the services of a personal assistant;
- communications systems and networks at Welch's homes;
- bodyguard security for various speaking engagements; and
- installation of a security system in one of Welch's homes and continued maintenance of security systems GE previously installed in three of Welch's other homes.

The SEC found that GE had an obligation to fully describe Welch's retirement benefits under Item 11 of Form 10-K and Item 8 of Schedule 14A, both of which require the information required by Item 402 of Regulation S-K. The underlying purpose of Item 402 disclosures with respect to executive compensation is "to improve shareholders' understanding of all forms of compensation paid to senior executives and directors, " and "enhance shareholders' ability to assess how well directors are representing their interests."

Disney

The SEC brought an enforcement action against Disney for failure to disclose information required by Items 402 and 404 of Regulation S-K concerning the compensation of directors and the employment of members of their families by Disney. Specifically, the SEC found that Disney failed to disclose

- that three adult children of members of the board of directors were employed by Disney in non-executive positions and received compensation in excess of the $60,000 disclosure threshold under Item 404(a);
- the wife of a member of the board of directors of Disney was employed, and earned more than $1,000,000 annually, by a company in which Disney held a 50% stake;
- it made payments to Air Shamrock Inc., a corporation owned by Roy Disney who was then a director, Vice-Chairman of the Board and an officer of Disney and managed by then Disney director, Stanley Gold, which exceeded 5% of Air Shamrock Inc.'s gross revenues for the use of its airplanes; and
- that it provided a director with secretarial services, a leased car and a driver as well as failed to disclose the value of these services in violation of Item 402(g) of Regulation S-K.

In the enforcement action against Disney, the SEC's primary focus was on Item 404 and the importance of disclosing related party transactions with director's family members. The SEC stated that Item 404 extends to transactions involving family members of directors because such information is intended to help a shareholder assess the director's performance and suitability to hold his or her position. "[S]hareholders should have the information concerning transactions and arrangements that might appeal to the natural human inclination to look favorably upon a family member's employment."

Remarks by the Director of the Division of Corporation Finance

Recent Trends

The Director noted that boards too often appear to default in favor of higher compensation, commensurate with a peer group that often is not reasonably determined. Noting however that the SEC's jurisdiction is over disclosure and oversight of the listing standards, and not the fiduciary duties of the directors, the Director identified two converging trends that have placed the issue of executive compensation on the SEC's rulemaking and enforcement agendas.

The first trend is that investors have concluded either that the interests of executives, demonstrated by their compensation, are not aligned with those of shareholders or that the available information about their compensation is too opaque or unhelpful to allow shareholders to determine whether there is alignment or not. Too much executive compensation disclosure is uninformative and designed more to avoid liability, than to inform investors.

The second is that too many issuers and their advisers have followed a pattern of opaque or unhelpful disclosure that confirms the worst suspicions of concerned investors, namely that there is something to hide.

Guiding Principle

The Director believes that too often compensation disclosure is omitted based on a literal reading of the rules. However, that approach, in his view, fails to take account of the overriding requirement to disclose "all plan and non-plan compensation for all services rendered that is awarded to, earned by or paid to the executive officers and directors covered in the proxy statement, whether it is paid currently or deferred." In his view, the "basic requirement to disclose all compensation takes precedence over the detailed requirements of the various tables in which disclosure is to be presented under our rules. **All** compensation must be disclosed."

If the company is considering whether to omit a payment or other information where disclosure is not specifically required under the SEC rules, the company must consider whether failure to make the disclosure is a material omission or makes what is disclosed misleading.

Specific Areas of Concern Relating to Disclosure of Perks

The Director's speech specifically highlighted concerns regarding the disclosure of perquisites, or perks. Among the specific areas of concern, the Director cited:

- ***The personal use of company planes and similar perks***. Simply stating that company executives must always fly in company planes (or drive in company cars, or accept any other benefit) for security reasons does not relieve a company from considering whether these benefits are perks.

- ***Characterizing what are actually perks as business expenses*** (such as housing, security systems, cars). One question to ask is whether it is an expense that is available to employees generally on a non-discretionary basis, like reimbursement for the taxi across town for a meeting, or whether it is a benefit for which only a chosen few are eligible (or selected on a discretionary basis).

- ***The valuation of perks.*** For example, the disclosures of large tax gross ups for perks that are themselves not disclosed, and a focus on the tax value of the benefit instead of the aggregate incremental cost to the company.

Specific Areas of Concern Relating to Compensation Committees

The Staff is concerned that compensation committee reports often contain boilerplate information that is not particularly informative. The Director believes that a significant number of compensation committees would benefit from taking a fresh look at their compensation committee reports and cited the Proposing Release on Executive Compensation Disclosure, Securityholder Lists and Mailing Requests (August 1993) as guidance that is still appropriate.

The rules require disclosure in the report of executive compensation policies, the specific relationship of corporate performance to executive compensation, the factors on which the CEO's compensation is based and a specific discussion of the relationship of a company's performance to

CEO compensation, including a description of each measure of company performance on which CEO compensation was based.

The Director cited the revised exchange listing standards that generally require a compensation committee of independent directors to determine or recommend executive, and especially CEO, compensation and noted that these listing standards provide a timely opportunity for companies and their boards to reexamine the way they have been looking at the role of the compensation committee and executive pay.

In particular, the Director cited various items that although not specifically required by the rules are worthy of consideration, both in and of themselves and as a possible basis for disclosure, before a report can be prepared. These include:

- the need for better focus on long-term performance of the company and its executives in all respects, not just short-term results or limited specific measures;
- a focus on the relationships with compensation consultants to ensure that the consultants work for the committee, not the executives whose pay is being considered; and
- the benefit of regularly evaluating all components of compensation, that is how each component of compensation fits into the overall compensation package to ensure it makes sense.

A discussion of developing best practices with respect to compensation committee reports is included in the next section of this memorandum.

What the Staff is Focusing On

The Director provided the following list of items that the Staff is considering:

- ***Perks***, including how companies might be inappropriately avoiding categorizing items as perks; how companies value perks, and whether there are better approaches to valuation. In particular, is incremental cost to the company the best approach where the object of the requirements is to disclose compensation?
- ***Retirement Benefits and Deferred Compensation,*** including the disclosure requirements, as well as companies' disclosure, related to SERPs and non-qualified deferred compensation plans, including their position regarding disclosure of above-market elements. The Staff is also looking at other retirement, severance and change-in-control elements and will be considering the impact on those disclosures, if any, of the American Jobs Creation Act, which includes provisions related to the taxation of non-qualified deferred compensation.
- ***Total Compensation***, including whether to require enhanced disclosure of total compensation and how that might be achieved.
- ***Named Executive Officers***, including whether the current criteria for determining the named executive officers is still appropriate. For example, the Staff is considering whether companies should be required to disclose the compensation of other specific officers, such as the CFO and/or general counsel.

- ***Director Compensation,*** including disclosure of overall director compensation, both to see if companies are following the current requirements, as well as whether the rules should be expanded.
- ***Compensation Committee Reports,*** including the current compensation committee report disclosure requirements and whether they adequately address disclosure of the policies, operation and determinations of the compensation committee.
- ***Related-Party Disclosure,*** particularly as it relates to executive compensation.

Developing Best Practices in Compensation Disclosure

Due to the recent focus by the SEC on executive compensation disclosure, as highlighted above by the Director's remarks, some trends are beginning to develop as companies move to improve their compensation disclosure, particularly with respect to the report of the compensation committee. Among the items in the compensation committee report, companies are including the following information:

- ***Total Compensation***. Companies are including a greater focus on the total compensation both from a disclosure standpoint as well as in respect of what the compensation committee considers.
- ***Process***. Companies are including greater detail as to how the overriding compensation philosophy and goals are utilized in determining overall compensation. Compensation committees are increasingly focusing on all elements of compensation (including severance packages and perquisites) as well as year to year comparisons.
- ***162(m) disclosure***. Companies are including greater disclosure relating to the goals of avoiding losing deductions for compensation.
- ***Compensation of CEO***. Companies are placing a greater focus on disclosing the total compensation of the CEO and how such compensation was determined.
- ***Independent Compensation Consultants.*** Companies are including greater detail on the role consultants play in determining compensation.
- ***Perquisites.*** Companies are including greater disclosure with regard to perquisites. In particular companies are disclosing items such as use of company aircraft, secretarial services, drivers and travel expenses for spouses.

Some additional practice tips have emerged in preparing the report of the compensation committee. These are:

- describe future plans of the compensation committee;

- if a consultant is relied upon to determine the compensation of an executive officer, consider disclosing the independence of the consultant or any relationships that may taint the independence of the consultant;

- address the concerns articulated by large shareholder groups; and

- disclose positive aspects of the company's compensation policy (such as the absence of perquisites or pay recovery).

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The SEC's recent challenges to disclosure of executive compensation, particularly with respect to perquisites, should serve as a reminder to companies as they prepare future proxy statements and annual reports. Companies should ensure that they have adequate disclosure controls and procedures to facilitate the inclusion of elements of compensation and benefits subject to disclosure in the company's proxy statement and annual report and that both the Disclosure Committee and the Compensation Committee are aware of these disclosure requirements. The potential for other enforcement actions in respect of disclosure controls and procedures is underscored by the reference to Rule 13a-15 (which requires the maintenance of disclosure controls and procedures) in the second enforcement action against Siebel Systems for violations of Regulation FD.

Any questions concerning the foregoing should be addressed to any of the following. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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