U.S. Securities and Exchange Commission

Speech by SEC Staff: "The Need to Know"

by

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Thank you Joe for that very kind introduction. I am very pleased to be here today at the inaugural session of the Rock Center's conference series and I want to extend my thanks to the entire Rock Center team for hosting the program today. I have been a big believer in programs like this one for a long time, and I wish you great success in your goal of providing "a public forum in which regulators can interact with leading scholars and industry experts" on important corporate governance matters. You have certainly assembled such a group of leaders today.

As you know, I was not on the staff when the Commission held its open meeting on January 17 and voted to issue the proposals which are the subject of this conference. In fact, as Chairman Cox noted earlier, I have been on the staff for only 14 days and a few hours. That was preceded by 11,359 days, and a few hours, in private practice. In light of my brief tenure on the Commission staff, it is perhaps not surprising that my remarks today are going to take as their starting point a private sector perspective on the proposals—that is, a perspective of someone outside the Commission. Although I am relatively new (okay, very new) to the staff and I am only going to offer comments that come from my past outside the Commission, I nevertheless fully appreciate the importance of the so-called standard disclaimer, so let me remind everyone that the views I'm going to express today are solely my own, and do not necessarily reflect the views of the Commission, or of any members of the staff other than myself.

The executive compensation and related disclosure proposals are, of course, just that—proposals. The comment period remains open through next Monday, April 10, and I repeat Chairman Cox's urging that you make your

voice heard: If you have comments, we want to hear them, on the public record. And the Commission, of course, will carefully consider all comments before deciding on the form of the final rules. Obviously none of us know which components of the proposals will be retained at this point.

Although there are no final rules yet, nor do we know when any final rules would be effective, I do not believe that public companies should simply comment on the proposals (which I encourage) and then wait to see where the chips may fall. In the Proposing Release,[1] the Commission has already given the registrant community a glimpse at what the future may hold, and I want to focus you today on several action items that could help avoid unpleasant surprises.

The Relationship of Knowledge and Disclosure

As many leaders of the securities bar have reminded us over the years, our federal securities laws are premised upon quality disclosure. Quality disclosure doesn't happen overnight or by accident. Achieving it requires hard work and constant attention. At the same time, our disclosure regime does not require that public companies disclose everything they know as soon as they know it. Nor do registrants even have to disclose everything *material* as soon as they know it. I believe, however, that they do *need to know* the relevant information. Only then can quality disclosure decisions be made.

As I have been thinking about the challenge I mentioned a moment ago—looking at the proposals as an opportunity to help prepare for the future—it seems to me that there are two broad categories of actions that corporate America can, and should, be taking now:

1. First, you should make sure that your company actually *knows* the relevant information related to your executives' compensation—recognizing, of course, that some of the information you should know may well have been brought into sharper focus by the proposals and that reflecting on some of this knowledge may actually prompt action now.

2. Second, you should make sure that the right disclosure in your public documents will follow when revised rules are adopted—by that I mean, you should review and prepare to revise your disclosure controls and procedures so as to position your company to fully and faithfully comply with any new requirements.

In my time today, I'd like to briefly discuss these two "action items" with you.

1. Knowing Your Company

Again, looking only at the proposals, if I were still in private practice there are a number of specific areas that I would strongly encourage my corporate clients to make sure they *know* now in order to prepare for the possibility

that additional disclosure might be required next year about events occurring this year. And as companies, their boards (including their compensation committees) and their management become more well-versed in these areas, they may not like the answers they find. As they ponder future disclosure, they may not like the picture these items paint of them. (And there will be a picture.)

As you know, at the heart of the proposals is a new reporting section called "Compensation Discussion and Analysis" which would provide narrative disclosure of a company's policies and decisions regarding its compensation of named executive officers. Companies would use the new CD&A, in effect, to tell their compensation stories. As companies think about those stories today, as I just said, they may not like the tales they will have to tell. Some companies may even determine it's advisable to make changes now. Any determination like that, of course, is up to the individual company and the people that run it. Different people may come out in different places when looking at the answers that emerge, and I am not going to offer any judgments today.

I would, however, like to briefly highlight a few of the areas of knowledge that seem most critical to me and that I might have suggested my corporate clients focus on. You should be thinking about these now—making sure you *know* these things at your company for this year and will be prepared for the aftereffects of sharing that knowledge if disclosing these things becomes required down the road. Fortunately, with the fairly long lead time that companies have between now and the likely effective date of any final rules, there is a golden opportunity to step back, consider and review your executive compensation and prepare yourself for any future, related disclosure obligations.

1. Total Compensation. One of the simplest of the Commission's proposals may have the most profound effect if adopted—that companies determine, aggregate and disclose the total compensation (that means, everything, in one number) awarded to, earned by or paid to each named executive officer. I know some have questioned if existing rules—even as amplified by Alan Beller's 2004 "all means all" speech—clearly oblige companies to disclose all kinds of compensation. If the proposals are adopted, that need will be crystal clear. And total compensation will also, for the first time, determine, in part, which officers are covered by disclosure. I suggest, therefore, that companies (including their compensation committees) should know now what the total compensation of all their senior executives is. What is each being paid, in total?

One further thought: Some compensation consultants, and others in the private sector, including some who are here today, have been recommending for some time now that companies use "tally sheets" to get at this very information. As I understand it, tally sheets are just spreadsheets that list out all possible aspects of a given executive's compensation and allow the compensation committee (or the full board) to see all those elements in one place and "tally them up" quickly and easily. Increasingly, we have heard demands that compensation committees use tally sheets. The key to my

mind is that companies and their compensation committees need to have a firm command of what total compensation is for each of their executives. If your company in the past has not been able to quickly and easily get its hands around this information, it seems to me that it's probably time to start.

2. Processes for Setting Compensation. Under the proposals, a public company would be required to disclose considerably more information about its compensation program—including the objectives of the program, what the program is designed to reward and not reward, and other information about the elements the company uses for compensation. Companies would also have new disclosure requirements about their compensation committees, including the committees' composition, processes and procedures.

I have often thought that the best way to learn something is to prepare myself to teach it—as I am sure many in this audience will appreciate. In a similar vein, companies may be well-served by preparing to tell their compensation stories tomorrow, and thus really learning the processes and procedures behind their compensation programs today. And by thinking about the story they'd like to tell, some companies may, perhaps, even decide to reshape their processes now. A determination like that is, again, up to the individual company. But it seems to me that all companies should make sure they know the facts today, if they do not already.

3. The Role of Executive Officers in Setting Compensation. Another example is the role of executive officers in setting compensation. The proposals draw attention to the involvement, if any, of executive officers in making those determinations. Under the proposals, companies will need to *know*, and be prepared to disclose, any role played by their executive officers in their compensation decisions, including disclosing any recommendation an executive has made about the amount or form of compensation the company pays. Recognizing that disclosure of an executive officer's role could be required in the future, again, perhaps companies will want to reshape that role today. Future required disclosure may also include the interaction between executives and any compensation consultants engaged by the company's board, which takes me to my fourth example.

4. The Role and Identity of Compensation Consultants. The proposals would require that companies disclose the identity of any compensation consultants whose services have been used by the board or the compensation committee.

- What are the nature and scope of their assignments? What instructions have they received?
- If the compensation committee engaged a consultant, did that same consultant do any work for the company or for any executives?

If companies do not know the answers to these questions, they might want to find out. If they do not like the idea of disclosing the answers, again, perhaps they should reconsider their arrangements.

5. More Examples. There are many more examples of what I would have advised my clients they should know today:

- What perks are you paying? If the proposals are adopted, companies will be required to disclose perquisites with more detail than most have provided in the past. Are you in a position to identify each perk that a named executive received and to specify the value of those perks meeting a particular threshold?
- Are you tracking the total compensation of a sufficiently inclusive group of your executives? As Commissioner Glassman noted at the Open Meeting in January, if adopted, the proposals could compel companies to monitor the compensation of a greater number of executives than just the five for whom disclosure is ultimately required.
- What amounts of compensation have been deferred by the executives during the year? What is the total amount of deferred compensation each executive has accumulated?
- What compensation is potentially payable upon an executive's retirement or severance? Upon a change in control of the company? Have you done what you need to do in order to provide that disclosure quantitatively?
- Do you have any non-executive employees that make more money than the least-paid named executive based on total compensation? As you know, disclosure is proposed.
- Are any of your named executives or directors pledging any of your shares as collateral? Disclosure of pledged shares, as of the latest practical date, is proposed.

And again, as you find the answers to many of these questions, your company, your board, and your compensation committee may not like what they see and may, perhaps, decide to make changes.

So let's go back now to the first action item: that is, companies should make sure they *know* the relevant information related to their executives' compensation now, including their internal processes and procedures for setting and managing compensation. As we have seen from the proposals, much of this information may be required to be disclosed in the future. Companies should take the opportunity now to become comfortable with what that disclosure will show investors.

2. A Process for Disclosure

This gets us to the second "action item" I want you to focus on. So far, I have talked about the substance of information being disclosed and knowing that substance. Now let's talk about process and what can be done there.

There are important policies and procedures regarding how public companies go about collecting and evaluating information. These processes are crucial to making quality public disclosures, and otherwise interacting with the capital markets and with the Commission. Considering whether your processes will be ready for the future disclosures suggested by the proposals is my second "action item".

Even before the Sarbanes-Oxley Act became law in July 2002, the Commission was already focused on the need for public companies to have sound and robust processes in place to ensure the timeliness, accuracy and completeness of their required disclosures.[2] Of course now, we have all become familiar with the term "disclosure controls and procedures" (or DCP), and we have come to understand the fundamental and critical place those occupy for public companies in today's markets. Given current events with respect to SOX 404, please remember that disclosure controls and procedures have been mandated since 2002 for all public companies—large and small, domestic and foreign—that are registered with the Commission, and they are required of public companies separate from SOX 404's internal control requirements that have drawn so much attention recently.

Eventually, of course, public companies will have to ensure that their disclosure controls and procedures cover any new executive compensation disclosure requirements that the Commission adopts. At this point, however, some of the information called for by the proposals is obviously not "required disclosure" and thus is not yet covered by the Commission's DCP requirements. I do believe, though, that companies would be well-advised to start thinking now about how their disclosure controls and procedures will need to be revised and updated to handle any new executive compensation disclosure requirements that may be adopted.

- Who will collect and aggregate these different types of information, which may not fit neatly with information collected to meet existing disclosure requirements?
- Who will be responsible for
  - maintaining the information?
  - for analyzing it?
  - for ensuring that the company's compensation story (that's the new CD&A) is told correctly (this may be more than having the technical executive compensation group, who puts the compensation packages together, generate accurate numbers)?
- Are existing disclosure committees properly positioned for the task? Do they include the right people?
- And, looking to the future, what could be done to prepare to present executive compensation information in any tagged data format that is appropriately developed and becomes available in the future?

Finally, don't forget that disclosure controls and procedures are, of course,

intricately connected to the certifications that chief executive and chief financial officers must provide for periodic reports pursuant to Section 302 of the Sarbanes-Oxley Act. Companies need to make sure their CEO's and CFO's are prepared for their certifications to cover all disclosure that is required for their periodic filings.

My private sector advice would be—"I highly recommend looking at these questions and starting to get ready now". The likelihood of quality disclosure rises significantly.

Conclusion

I started off talking about the relationship between disclosure and knowledge. Only with quality knowledge can quality disclosure result. I am sure that many public companies are already monitoring and retaining—making sure they *know*—the types of executive compensation information that they may be required to disclose in the not-too-distant future. If your company is not among that group, however, then I would encourage you to treat the proposals as a wake-up call. Use them to reassess what you know and how you know it. Not only that, but how would you tell it to others? Move through this year, the remainder of this proxy season, with an eye toward the next. If the proposals were final rules, what would you be disclosing? How would your executive compensation (and the processes for determining it) look in next year's proxy statement? Are you keeping track of all the moving pieces? And, perhaps most importantly, do you (and your board) like the picture of your company that those pieces paint? Will your investors? There is no reason for any company to let any of this "sneak up" on it. To my mind, one of the clear benefits of the timing of the proposals is that it has offered most companies a long look at what might be coming down the pike for them.

As many have pointed out, the Commission's proposals are all about disclosure. Chairman Cox made crystal clear at the Commission's Open Meeting in January that the Commission does not seek to regulate the substance of executive compensation at public companies. Those determinations are appropriately dependent upon the business judgment of boards of directors and their committees.

For my part, I have tried to share with you my thoughts on what types of information, what types of *knowledge*, companies and their boards should make sure they have going forward, with an eye toward possible future disclosures. Companies need *to know*: only then can quality disclosure decisions be made. And investors deserve no less. That of course is ultimately why we're all here, and I will close with that thought. Thank you again for including me at your conference and for your time and attention.

Endnotes

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[1] Release No. 34-53185, "Proposed Rule: Executive Compensation and Related Party Disclosure," January 27, 2006.

[2] See Rule 13a-15(e) under the Securities Exchange Act of 1934. See also Release No. 34-46079, "Proposed Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports," June 17, 2002.

http://www.sec.gov/news/speech/2006/spch040306jww.htm