

Effective CD&A Disclosure

The Basics

The Compensation Discussion and Analysis (CD&A) is a required part of a company's annual proxy statement. Its purpose, per SEC rules effective in 2006 is to "provide material information about the compensation objectives and policies for named executive officers" and "put into perspective for investors the numbers and narrative that follow it."

The importance of the CD&A has increased dramatically as a result of mandatory Say-on-Pay shareholder votes on executive compensation. In addition to presenting the SEC-required elements, the CD&A is a company's primary opportunity to educate shareholders about the company's commitment to paying for performance. It is by far the most cost-effective means of doing so and should be used to the fullest. Given that, the CD&A should:

- Tell the company's story.
 - Put executive pay into the context of the business strategy and the competitive environment.
 - Explain the compensation philosophy and how each pay program supports it.
 - Explain the role of the Compensation Committee vs. that of management in determining pay.
 - Provide the business reasons behind sensitive items such as employment contracts, severance pay, bonus payouts during periods of declining earnings, etc.
 - Discuss issues that could arise as a result of the policies of Institutional Shareholder Services, Inc. (ISS) and other shareholder advisory groups.
 - Ensure that certain best practice policies are disclosed including incentive plan caps, clawbacks, anti-hedging policies, etc.
 - Discuss analyses the Committee has commissioned or reviewed that assess the appropriateness of pay given the company's performance.
- Discuss company performance and how it impacted pay.
 - Differentiate clearly between pay opportunities and actual payouts. If the required proxy tables do not tell the full story, supplement them as necessary to present the full "actual pay" picture and the rationale for key decisions.
 - Discuss business achievements and business challenges and how they affected results.
- Be written in "plain English" (required by the SEC) that shareholders can understand (avoid "legalese").
 - Approach the discussion from the viewpoint of a shareholder and anticipate questions.
 - Provide clear and concise discussion using tables and charts to enhance the narrative.
 - Use headings, short sentences and short paragraphs.

The Details

Requirements

The SEC requires that a CD&A answer the following six questions, as well as provide other relevant information:

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How do each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?

Process

Develop an effective process.

- Select the responsible team
 - Have a single person oversee the process, manage its progress and be responsible for the final draft.
 - Select a primary author, one with excellent listening and writing skills.
 - Determine the team: HR, Legal, Accounting, Communications, outside advisors.
 - Establish the Committee's role in reviewing the CD&A and determine how Committee meeting dates impact timing.

Analysis to Accompany the Discussion

With a mandatory Say-on-Pay vote, providing an analysis of executive compensation relative to company performance is crucial. Stating that pay is "competitive with the market" is not enough. Shareholders want companies to pay executives for performance.

- Discuss the company's previous year's performance and how it affected executive compensation. What were the key points over the past year?
 - Was a long-term capital project put into service or a business line divested?
 - How did the previous year's or period's performance affect executive incentive payouts—annual and long-term?
 - Did the previous year's performance drive any compensation-related decisions made during the year?
- If appropriate, discuss performance compared to industry peers or the overall stock market and the effect on the company's approach to executive compensation.
 - Is the company creating value for the shareholders? How does one-year total shareholder return compare to peers? Three-year? Five-year? (A chart might demonstrate this concept well.)
 - How does performance compared to peers affect executive compensation?

“Plain English”

While writing in “plain English” seems easy enough, the SEC “Plain English Handbook” is 77 pages. The following guidelines may be helpful, however.

- Lead with a “year in review” section that explains the decisions made by the Committee that year, and payouts that resulted from the plan designs and performance during the year
- Refer to the company in a *brief manner*, either in the first person such as “we” or “our,” the commonly used company name, or a brief mention such as “the Company.”
- Use the *active voice*. For example, “The Committee reviews business results ...” instead of “Business results are reviewed by the Committee...”
- Ensure *consistent use of terms*. For example, the annual incentive may be variously described as the annual incentive, annual bonus, annual cash award, annual performance compensation, etc.
- Use *layman’s terms* instead of technical or legal jargon.
- *Anticipate shareholder questions*. Tell the story of performance results and how that affects executive pay. Ask what puzzle piece is missing to understand the big picture.
- Include *headings* using logical flow for the information presented. This approach makes it easier to eliminate repetition and to find specific information.
- Use *bullet point lists* instead of narrative when listing items.
- *Avoid redundancy*; it lengthens the CD&A unnecessarily and can lead to errors in drafting.
- Incorporate *charts and tables* particularly when communicating a lot of data. Use them in lieu of (not in addition to) the narrative.
- Eliminate *unnecessary words, phrases and sentences* that do not bring value to a message.
- Be *clear, concise, transparent and thorough*. The CD&A should answer questions instead of generating more.

Conclusion

An effective CD&A does two jobs: meets the SEC’s requirements and tells the compensation story effectively.