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NEW CONSIDERATIONS REGARDING THE REPORTING OF EQUITY AWARDS IN THE SUMMARY COMPENSATION TABLE

An interpretive position recently taken by the Staff of the Securities and Exchange Commission in correspondence with Verizon Communications Inc. has potentially broad implications for reporting compensation in the Summary Compensation Table. The correspondence involved the characterization of a performance-based equity award under which the compensation committee had significant discretion to adjust the payout based on non-objective criteria. In the correspondence, the Staff took the position that a portion of the award should have been disclosed in the Summary Compensation Table in the year it was earned, rather than the year in which, based on Verizon's accounting, the grant date occurred. The conclusion is notable because:

- it opens up the possibility that many common types of equity awards will not be reportable in the Summary Compensation Table in the year of grant based on the grant date fair value determined in accordance with applicable accounting rules, notwithstanding that the Staff strongly backed that approach in connection with the 2006 revisions to its rules on the basis that it provides clear guidelines that would facilitate comparisons of compensation practices among companies;[1] and

- it suggests that the Staff may be more comfortable than is generally appreciated with the reporting of certain equity awards based on the service period for which they are earned, rather than the grant date of the award.[2]

The Staff may view the facts in Verizon as exceptional, and take the view therefore that its position in the situation does not have broad implications. The Staff focused on compensation that was contingent on six criteria, two objective and four subjective, and noted that substantial compensation was paid even though neither of the objective criteria was met. The criteria were not assigned weightings in advance in respect of their impact on

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[1] Some registrants may welcome additional flexibility in this regard, insofar as it gives them the opportunity to report compensation in a manner that more closely aligns actual payments of compensation with the performance periods to which the compensation relates. Such flexibility may help companies show the correlation between pay and performance, which has become a key concern for shareholders, particularly in respect of say on pay voting.

[2] Along the same lines, see the Staff's Regulation S-K Compliance and Disclosure Interpretation ("C&DI") 119.24 (March 1, 2010), in which the Staff concludes that in certain circumstances the "service inception date," rather than the grant date, should dictate the year for which equity awards are included in the Summary Compensation Table.

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the compensation to be paid. While these facts do not seem exceptional, there may be other facts that were viewed by the Staff as unusual and material. Nevertheless, based on the public record the Staff's approach could be applied in a way that affects the reporting of many typical awards that vest based in significant part on subjective or discretionary criteria. It is notable in this regard that the Staff's analysis bifurcated an equity award that Verizon argued should be treated as a single award, since many awards have some qualitative or discretionary aspects that could, in theory, be treated as separate from the objective portions of the awards.[3] At a minimum, the Verizon correspondence leaves uncertainty as to where the analytical lines should be drawn.[4]

This memorandum provides further details about the structure of the equity-based award that was the subject of the Verizon correspondence and the Staff's interpretive position in the correspondence, and then discusses some of the potential implications of the Staff's position.[5]

Terms of the PSUs

The correspondence between the Staff and Verizon focused primarily on performance stock units ("PSUs") that Verizon granted to its CEO under the Verizon Long-Term Incentive Plan ("LTIP") for the three-year performance period from 2008-2010. According to Verizon's 2009 proxy statement (reflecting 2008 compensation), each PSU represented a share of Verizon common stock, and the PSUs were cash-settled based on the value of Verizon common stock on the last trading day of 2010.[6]

The Compensation Discussion and Analysis ("CD&A") in Verizon's 2009 proxy statement states that the company's compensation committee determines an executive's compensation opportunity by assuming that he or she will earn 100% of the PSUs initially awarded in any performance cycle, but the number of PSUs that are actually earned and paid is determined based on Verizon's total shareholder return ("TSR") compared to a designated

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[3] Query how the Staff's approach would apply, if at all, to 'negative discretion plans,' where the maximum amount of an award is determined based on an objective performance measure, but the company reserves (and in fact exercises) discretion to decrease the actual award that is paid. See, in this regard, the discussion of negative discretion in C&DI 119.02 (January 24, 2007).

[4] If there are no bright lines, then legal judgment may often be necessary to determine proper reporting of equity awards in the Summary Compensation Table. For example, judgment may be necessary to distinguish an equity award as to which there is *not much* discretion and that, therefore, should be reported in the year of grant based on grant date fair value from an equity award that has *a lot* of discretion associated with its vesting conditions and therefore should be reported (in whole or in part) in a manner consistent with the approach advocated by the Staff in the Verizon correspondence.

[5] The discussion of the terms of the awards is based solely on Verizon's public filings and correspondence with the Staff. The Staff's comments can be found at:
http://sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000732712&type=upload&dateb=&owner=exclude&count=40, and cover the period from June 28, 2011 through November 10, 2011. Verizon's responses can be found at:
http://sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000732712&type=corresp&dateb=&owner=exclude&count=40, and cover the period from July 22, 2011 through November 9, 2011.

[6] The PSUs accrued dividend equivalents during the performance period.

peer group over the three-year performance cycle. In addition, the compensation committee had authority to recommend that the board of directors increase the CEO's payout based on a number of additional performance criteria, some of which were not objective, subject to a maximum total payout of 200% of the PSUs initially awarded to him.

According to the CD&A, the specific criteria applicable to the strategic component of the CEO's 2008-2010 PSUs were: "(i) producing double-digit consolidated earnings growth each year; (ii) maintaining Verizon Wireless's market leadership position; (iii) sustaining Verizon's top line consolidated total revenue growth at 5-6% per year; (iv) developing Verizon's executive talent pool and preparing Verizon's succession plan; (v) participating in and providing leadership to various industry forums; and (vi) implementing key policy initiatives." The CD&A also stated that "[t]he Committee has not assigned a particular weight to any of these strategic initiatives and has the discretion to recommend to the Board whether and to what degree the award should be increased. However, if Verizon's relative [TSR] performance during the measurement period does not merit any payout of the PSUs, Mr. Seidenberg *may not* receive any payment of his 2008 PSU award (including any portion relating to these strategic initiatives)."[7]

Disclosure about the PSUs

Verizon described the terms of the CEO's PSUs in various places in its 2009 proxy statement. Apart from the discussion of the terms of the PSUs in the CD&A described above, Verizon reported a value for the grant of the PSUs in the Stock Awards column of the Summary Compensation Table for 2008 based on Verizon's accounting expense consistent with the instructions to Item 402(c)(2)(v) and (vi) of Regulation S-K. The reported value reflected an assumption that 85% of the PSUs awarded would be earned. Verizon also disclosed the grant of the PSUs in the Grants of Plan-Based Awards Table, including the number of PSUs that would pay out at threshold, target and maximum. It appears that Verizon also included the target number of PSUs and dividend equivalents in the number of unvested equity units, and the year-end fair market value of the maximum number of PSUs that could pay out, in the Outstanding Equity Awards at Fiscal Year-End Table.[8] Finally, in its discussion of its severance and change in control payments and benefits, Verizon included the year-end fair market value of the PSUs at target, since outstanding PSUs would immediately vest and become payable at target levels on a change in control.

[7] Verizon's 2009 proxy statement at 36 (emphasis supplied). That the objective condition (i.e., the relative TSR condition) is applicable to the entire strategic component of the CEO's PSU award, and the way in which it links the two components of the award, seem to support Verizon's position that the CEO's PSU award should not be bifurcated, but these factors apparently were insufficent in the Staff's view to justify Verizon's reporting approach.
[8] In a footnote to the applicable columns in the Grants of Plan-Based Awards table, Verizon also disclosed the dividend equivalents that had accrued on the PSUs through 2008, and it included these in the Outstanding Equity Awards at Fiscal Year-End Table.

In subsequent years, Verizon provided more detailed disclosure regarding the potential payout of the 2008-2010 PSUs in footnotes to the Summary Compensation Table. In particular, in both the 2010 and 2011 proxy statements, Verizon included a table in the footnotes to the Summary Compensation Table that compared the grant date fair value of the PSUs that it included in the Summary Compensation Table to the maximum value of the PSUs.

The Correspondence

In its initial letter, the Staff asked Verizon to explain why the portion of the 2008-2010 PSUs that paid out based on the level of achievement of specific strategic initiatives applicable only to the CEO (approximately $13.8 million) should not be considered a bonus and disclosed as such in the Summary Compensation Table in the year earned, which the Staff viewed as the final year of the performance period. The Staff particularly noted that "neither of the two objective measures (revenue and earnings growth) were met" and directed Verizon to review C&DI 119.02, which addresses disclosure of a discretionary annual bonus that is not based on any performance criteria.[9] In its response, Verizon reiterated its characterization of the PSUs as an equity award, disclosable in the Summary Compensation Table solely in the year of grant based on its grant date fair value (determined based on the probable outcome of the specified performance conditions). Verizon emphasized that the PSUs were based on achievement of performance conditions specified in advance related to the achievement of specific strategic initiatives and that the ultimate number of PSUs awarded was determined within the framework of the original terms of the award, which set a maximum number of PSUs that could be earned by the CEO. Verizon also discussed its analysis of the awards as share-based payments pursuant to Accounting Standards Codification 718, *Compensation – Stock Compensation* ("ASC 718").[10]

Over several months of correspondence and telephone calls with Verizon, the Staff persisted in its view that the portion of the 2008-2010 PSUs that was subject to the additional performance criteria should be treated separately from the rest of the PSUs as a discretionary award in the year earned.[11] In its final letter to the Staff, Verizon stated that, in its 2012 proxy statement, it would include amounts awarded with respect to the strategic component of the 2008 PSUs (and the strategic component of a similar PSU award covering

[9] In the correspondence, the Staff does not appear to have distinguished between purely discretionary determinations and subjective assessments of qualitative performance goals. It is possible that the fact that Verizon did not assign specific weights to the various subjective criteria established under its plan contributed to that result.
[10] Specifically, Verizon states that "we account for the awards in question under [ASC 718] . . . [T]he value of the 2008-2010 PSU award at the grant date (based upon the probable outcome of the specified performance conditions to which such award was subject) has been included in Mr. Seidenberg's compensation for the corresponding year of grant under the "Stock Awards" column of the Summary Compensation Table. . . . [I]n our accounting treatment of the 2008-2010 PSU Award, we do not distinguish between what the Staff has identified as the "First Component" and the "Second Component" [i.e., the portion related to TSR and the portion related to strategic initiatives]. We do not believe there are any alternative accounting treatments that would be appropriate for determining the expense for the 2008-2010 PSU Award."
[11] The Staff stated first that "we believe the grant date for this Second Component of the PSU Award occurred upon settlement" and subsequently that "we believe the second component does not fall within the scope of ASC 718."

the 2007-2009 performance period) as stock awards granted on the last day of the applicable performance period in the Stock Awards columns of the 2009 and 2010 line items of the Summary Compensation Table for the CEO. Verizon also agreed that it would make similar disclosure if any amount was awarded with respect to the strategic component of the CEO's 2009-2011 PSU award. The Staff apparently backed-off its initial position that the amounts were purely discretionary cash bonuses that should be reported in the bonus column (as noted above, the awards were cash-settled). It agreed that Verizon could disclose the amounts in the Stock Awards column of the Summary Compensation Table, albeit for the year earned and not for the year granted under Verizon's application of ASC 718.[12]

Implications of the Correspondence

Given the heightened scrutiny of executive (and particularly CEO) compensation and continued demands for an "all-in" number that can easily be republished and compared among companies, the Staff's position may have implications beyond the specific facts presented by the Verizon PSUs. In particular, the Verizon correspondence raises the question of when a discretionary or subjective portion of an equity incentive award should be treated as a separate award for Summary Compensation Table purposes. There would likely be differences in the timing of disclosure, as well as the amount of compensation disclosed, depending on whether an arrangement is treated as a single award or two separate awards. There could, as a result, also be an impact on the identity of a company's "named executive officers" in respect of a particular year. The required determination may be highly dependent upon the specific facts and circumstances surrounding the arrangement in question, and may require close collaboration among a company's compensation committee and advisors, as well as the company's accountants.

In sum, the Verizon correspondence calls into question whether in most cases the application of ASC 718 to the facts will result in a clear cut definitive approach for disclosure of equity awards in the Summary Compensation Table based on the year in which the grant date occurs and the grant date fair value of the awards. Accordingly, for any equity plan that has a discretionary or subjective component or that utilizes qualitative performance targets in whole or in part, companies should consider whether, given their individual plan design and relevant facts and circumstances, an award may, in whole or in part, be more properly characterized as a bonus (or discretionary stock award) for the year *earned*, rather than a Stock Award for which grant date fair value should be included in the Summary Compensation Table in *the year of grant*.[13]

[12] Ultimately, while the public record is incomplete, it appears that Verizon and the Staff agreed more on a disclosure approach than on the application of the accounting principles to the facts.

[13] Note that for an equity award with a multi-year performance period, this may mean that a portion of the award is disclosed as a Stock Award in the Summary Compensation Table based on its grant date fair value in the year of grant, and a portion of the award is disclosed as a Stock Award in the Summary Compensation Table when the company makes its assessment about whether any portion of the award that related to the subjective or qualitative targets was earned (which appears to have been the ultimate resolution in the Verizon correspondence).

In our view, in light of the issues discussed above, companies would also be well-served to review the characterization of their *annual cash* incentive awards where payments are based on achievement of both quantitative and qualitative performance targets. Since the proxy disclosure rules were revised in 2006, companies have been required to assess the level of discretion that applies to their annual cash incentive awards in determining whether to categorize those payments as "bonuses" or "non-equity incentive plan compensation." C&DI 119.02 and other SEC comments contemplate bifurcating bonus/non-equity incentive plan disclosure for a single award, and the Verizon correspondence suggests that, in the Staff's view, unweighted qualitative targets (even those established at the outset of a performance period) may indicate that at least some component of an award is discretionary. Arguably it makes little practical difference how these amounts are disclosed, since all annual incentive payouts appear in the same year in the Summary Compensation Table, but many companies prefer to categorize their annual incentives entirely as non-equity incentive plan compensation, and not as discretionary bonus, because of a perceived shareholder preference for formulaic awards.

Finally, we note that the Staff took the position in the Verizon correspondence that, for accounting purposes at least, the portion of the applicable PSU award subject to qualitative performance goals should not be treated as having been granted at the "service inception date." That view has accounting implications for awards with multi-year performance periods. The publicly available correspondence does not clearly indicate whether the Staff required Verizon to adjust its financial accounts retroactively to reflect that view.

Please contact any of the partners or counsel listed under Corporate Governance or Executive Compensation and ERISA in the "Practices" section of our website (www.cgsh.com) or any of your other regular contacts at the firm for further information about the matters discussed above.

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