



SEC STAFF ISSUES COMMENT LETTERS ON EXECUTIVE COMPENSATION

Last year, the SEC adopted far-reaching revisions to public company executive compensation disclosure requirements, effective with the most recent proxy season. The new “principles-based” rules—adopted as a result of press and investor attention to the size of some executive compensation packages and the allegedly opaque public disclosure relating to them—contained both expanded tabular information and a new Compensation Discussion & Analysis (CD&A) meant to provide management’s view of the compensation process and its results.

After Chairman Cox admonished corporate lawyers in March that they were “overlawyering” the executive compensation sections in proxy statements, leading to 30- and 40-page descriptions, you would have thought that the staff would have used its “principles-based” approach in its initial set of comments in the executive compensation area, which it began issuing last week. You would have been wrong.

Based on comment letters our clients have received, the staff has been issuing lots of detailed comments, many of which are boilerplate and are not necessarily tailored to the particular company’s disclosure. In many cases the comments essentially restate the requirements in the new rules, not necessarily because the company has not fully complied with the requirements but because the staff is unable to ascertain whether the company has complied. The staff’s approach appears to be that if the information does not appear, it must have been overlooked.

Most of the comments have been issued as “future filing” comments that do not require amendment of last season’s proxy statements (or their Forms 10-K into which the executive compensation disclosures often are incorporated by reference), but instead permit companies to revise their disclosure prospectively by confirming in writing that they will do so and explaining how they intend to comply. Some of the comments request additional information so that the

AUGUST 2007

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¹ The text of his remarks on August 14, 2007 to the American Bar Association can be found at <http://www.sec.gov/news/speech/2007/spch081407jww.htm>.

staff can “better understand” the company’s disclosure. However, as John White, the Director of the SEC’s Division of Corporation Finance, cautioned in a recent speech,¹ some companies may need to amend Part III of their Forms 10-K, notwithstanding that the staff’s comments relate to last season’s proxy statements and meetings have already been held.

Companies need to be careful when responding to staff comments. Caution is especially warranted when dealing with comments relating to withholding of performance targets, because as Mr. White specifically noted last June, the staff could ask the company to amend its Form 10-K if it concludes that an issuer improperly withheld information in that area.²

The comment letters issued by the staff resulted from its targeted review of executive compensation disclosures in several hundred proxy statements, with an emphasis on larger companies. As the second phase of its targeted review project, the SEC is preparing a comprehensive report on executive compensation disclosures that will be based on what it observed in its reviews and issuer responses. We expect that the staff’s

report will be released in time for the 2008 proxy season. In addition, the SEC staff continues to periodically post new executive compensation interpretations on the SEC website.

The remainder of this advisory highlights areas of SEC staff focus, makes suggestions on how clients should proceed when responding to comments, and tries to forecast what this process might mean for next year’s proxy statement.

FOCUS OF THE SEC COMMENTS

Here are some areas in which the staff has been commenting:

Performance Targets. In the adopting release for the new rules, the SEC carried over the prior concept that companies are not required to disclose performance target levels or other criteria involving confidential and sensitive information if the disclosure would result in competitive harm to the company and the information has not been publicly disclosed. However, the company bears the burden of proving that this standard is met. The standard is the same as applies to confidential treatment requests, and it can be difficult to satisfy—companies need to demonstrate that disclosing the information would cause competitive harm to the company, that the risk of harm outweighs an investor’s need to know the information, and that the company has otherwise kept the

information confidential.³ Companies should bear the following in mind when responding to comments in this area:

- Where performance targets have been withheld, the staff is generally requesting that the company’s justification for withholding this information be provided. If the SEC is not persuaded that the company has met the required standards, the company will be required to publicly disclose the information, and the staff could require that Part III of the company’s Form 10-K be amended.
- Where there is sufficient justification for withholding performance targets, companies are required to discuss the difficulty or likelihood of achieving the undisclosed target levels or other performance factors or criteria. The staff does not appear satisfied with broad statements such as “it is intended to be difficult for executives to meet the company’s performance criteria” or “targets will be achievable provided executives meet individual performance goals and targets.” In discussing how difficult it will be for an executive or how likely it will be for the registrant to achieve target levels or other

¹ The text of his remarks on August 14, 2007 to the American Bar Association can be found at <http://www.sec.gov/news/speech/2007/spch081407jww.htm>.

² See “SEC’s White Talks 404, IFRS, Executive Pay” Compliance Week (June 6, 2007).

³ See [Staff Legal Bulletin No. 1A Jul. 11, 2001](#), Confidential Treatment Requests (with Addendum) (Revised).

factors, the staff is requesting as much detail as necessary without disclosing information that poses a reasonable risk of competitive harm.

- Because of the public availability of comment letters and company responses, a company's response to SEC comment letters will not be confidential unless the company requests confidential treatment of its response.

Functions and Activities of Employee Benefit Consultants. The staff is requesting that issuers fully address the nature and scope of the consultant's assignment, including the material elements of any instructions or directions given to the consultant, whether the consultant is engaged directly by the Compensation Committee, and the consultant's specific contributions and findings with respect to the company's pay practices and amounts. We would not be surprised if the staff ultimately seeks data and analysis contained in compensation and benefit consultant reports or has companies advise why they are not material. The staff's views regarding proxy statement disclosure of the analysis underlying fairness opinions might provide a model it ultimately will follow, although there are substantial grounds to think that such a model would be inappropriate in light of the nature and purposes of the CD&A.

Benchmarking. Where a company indicates that compensation targets

a percentile (e.g., median) or range for executives in similar positions at other companies, the staff may require disclosure regarding the identity of the companies and the amount or range of peer compensation. If a company benchmarks different elements of compensation against a subset of the peer group or a different group, the staff will require the issuer to identify the companies in each sub-group. The staff may inquire whether actual compensation fell within the targeted percentile or range and, if not, the reasons it fell outside the parameters.

Elements of Compensation. The staff seems to be particularly interested in analysis regarding the different components of compensation and how amounts paid under each element affect decisions regarding amounts paid or awarded under other components of a company's compensation program. Staff comments request a focused discussion of the policies governing the allocation of current versus future, and cash versus equity, compensation.

Analysis of the Compensation Awarded Each NEO. Staff comments request substantive analysis and insight into how the Compensation Committee determined the compensation awarded to named executive officers (NEOs), including the size of the annual cash incentive awards to NEOs and the basis for its specific payout determinations. Companies may be asked to provide an analysis of the extent to which target

or maximum levels of performance goals were achieved (or failed to be met) and how achievement of corporate financial, strategic, and operational objectives and individual goals resulted in specific payouts under each element of compensation for each NEO, including how they were weighted and factored into specific compensation decisions. The staff may request an explanation of any material differences in compensation policies with respect to individual NEOs.

Discretion in Granting Awards. Staff comments in this area request clarification on whether the Committee can exercise discretion in granting awards even if performance objectives are not met and whether any actual exercise of discretion pertained to one or more specified NEOs or to all compensation subject to relevant performance goals.

Change of Control and Termination Payments. As a result of the new disclosures requirements adopted last year, many companies included complex tables in their proxy statements showing potential payouts that would be made under various triggers in change of control and termination provisions. The staff seems to be taking this one step further. SEC comments request disclosure concerning how the Compensation Committee determined that the payment and benefits levels under various circumstances that

trigger payments or the provision of benefits upon termination of employment were appropriate. Issuers may also be requested to provide disclosure regarding how these arrangements fit into the company's overall compensation objectives and affect decisions made regarding other compensation elements and the rationale for such decisions.

SUGGESTIONS FOR RESPONDING TO STAFF COMMENTS

Companies should continue to use the same disclosure controls and procedures in preparing their response to the staff's comments that they used when initially preparing their proxy statement. The Sarbanes-Oxley Act requires companies to have robust disclosure controls and procedures, which must cover the company's CD&A.

A company's CD&A is *filed* rather than *furnished*, and to the extent that the CD&A and any of the other disclosure regarding executive officer and director compensation or other matters are included or incorporated by reference into a periodic report, the disclosure would be covered by the certifications of the company's principal executive officers and principal financial officers under the Sarbanes-Oxley Act.

In addition, the report of the Compensation Committee must state that the Committee has reviewed and discussed the CD&A with

management and, based on the review and discussions, recommended to the board that the CD&A be included in the company's Form 10-K and, as applicable, the company's proxy statement. Therefore any proposed response to the staff should first be vetted with the Committee.

The staff is generally requesting that companies respond in about 30 days from the date of its comment letter or "tell us by that time when you will provide us with a response." If a company needs an extension in order to implement its disclosure controls and procedures, we believe the staff will be amenable to a reasonable extension of the deadline.

LOOKING AHEAD

Recognizing the challenge associated with compliance with the executive compensation disclosure rules, many companies began planning for their 2007 proxy statements in late 2006 and early 2007. It is not too early to start reviewing the SEC staff comments issued to other companies and the related responses, as they become available, to determine how your proxy statement would have fared had you received the same comments. Adjustments in the form of disclosure made now will save time later and better enable companies to plan to gather the requisite information during the busy proxy preparation season.

Some SEC staff comments may lead some companies to modify their

compensation processes in light of the disclosure implications. This is particularly important to consider in advance of the critical year-end compensation decisions regarding cash bonuses and new equity or other performance grants. The content, evaluation, and use of reports from compensation consultants might also be reconsidered in light of the some of the staff comments.

For these reasons and others discussed above in connection with the comment response process, companies may wish to review the direction of the staff's comments and proposed changes in processes and disclosures with board compensation committees. Our experience with the new rules last year demonstrated that the new rules and their implications were a topic of great interest at the board level. Any significant changes are sure to be as well.

We hope you found this advisory useful. If you would like more information, please contact your Arnold & Porter attorney or:

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