

CLIENT ADVISORY

SEC STAFF PUBLISHES ITS OBSERVATIONS ON EXECUTIVE COMPENSATION DISCLOSURE

On October 9, 2007, the SEC staff released its much-awaited observations on executive compensation disclosures¹ based on its initial review of the executive compensation disclosure in 350 public company proxy statements. The staff's report generally summarizes the principal comments that it had provided to companies. But because the staff's review is ongoing, the report did not offer insight into how companies might propose to revise their disclosure in response to staff concerns—which would have been much more interesting.

As we noted in our [August 2007 Client Advisory](#), the SEC's report represents Phase Two of the staff's targeted review of executive compensation disclosure in issuer proxy statements under the Commission's new and enhanced executive compensation rules. Phase One resulted in the issuance of several hundred comment letters to issuers in August and a second wave of letters in late September.

STAFF URGES COMPANIES TO FOCUS ON ANALYSIS AND A CLEARER, CRISPER PRESENTATION

Two principal themes emerged from the staff's initial review of issuer proxy statements and its individualized comments to these companies. The staff urges companies to focus on analysis and a clearer, crisper presentation.

It's What You Say (Analysis). The Compensation Discussion and Analysis should focus on *how* and *why* a company arrives at specific executive compensation decisions and policies. This does not mean the disclosure should be longer or more technical. Generally, a shorter, crisper and clearer presentation would be better. The emphasis should be on helping readers understand the basis and context for granting different types and amounts of executive compensation.

And How You Say It (Presentation). The manner of presentation is important. The staff urges issuers to use plain English and organize tabular and graphical information in a way that helps readers understand the disclosure. Companies should provide more direct, specific, clear and understandable executive compensation disclosure. Companies should consider providing an executive summary, creating tables or charts tailored to the company's particular executive compensation program, and giving further consideration to how they can make the disclosure more meaningful.

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Washington, DC
+1 202.942.5000

New York
+1 212.715.1000

London
+44 (0)20 7786 6100

Brussels
+32 (0)2 517 6600

Los Angeles
+1 213.243.4000

San Francisco
+1 415.356.3000

Northern Virginia
+1 703.720.7000

Denver
+1 303.863.1000

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¹ The report, entitled "Staff Observations in the Review of Executive Compensation Disclosure," can be found at <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>

PRINCIPAL AREAS OF COMMENT

Here are the areas of comment discussed:

Manner of Presentation

In a number of instances, the staff suggested ways it thought companies could improve the manner in which they presented their executive compensation disclosure, e.g., by making some items of disclosure more prominent or by emphasizing in their Compensation Discussion and Analysis (CD&A) how and why they established compensation levels, and de-emphasizing and shortening lengthy discussions of compensation program mechanics. The staff's comments focused on format and clarity:

- ***Format.*** The staff commented on the format or manner of presentation where they found it adversely affected the overall readability of the company's disclosure. Where a company placed its required compensation tables before the CD&A, the staff asked it to relocate the tables so that they would follow the CD&A. Approximately two-thirds of the companies reviewed included charts, tables and graphs not specifically required by the rules. The staff generally found these helpful. Generally, the staff found it helpful when companies included an extra table in which they presented information regarding potential payments upon termination or change-in-control. The staff suggested to some companies that they disclose in this table the total amounts they would be required to pay their named executive officers upon termination or a change-in-control. A few companies included alternative summary compensation tables. Where a company presented an alternative summary compensation table that the staff found confusing or inconsistent with the revised rules, they asked the company to de-emphasize the alternative table and ensure that it was not presented more prominently than the required table. Companies also were asked to explain differences between compensation amounts in the alternative table and those presented in the required tables.
- ***Clarity.*** The staff found that, in several instances, companies made a good faith effort to provide clear and understandable disclosure, but fell short of full compliance with the underlying disclosure requirements. Where

the staff found that a company presented boilerplate disclosure, the company was asked to provide a clear and concise discussion of its own facts and circumstances. For example, the staff asked a significant number of companies to replace boilerplate discussions of individual performance with more specific analysis of how the compensation committee considered and used individual performance to determine executive compensation.

Compensation Discussion and Analysis

Because CD&A is principles-based, many companies were asked to enhance their analyses of compensation policies and discussions, including how they determined the amounts of specific compensation elements. In providing these comments, the staff's goal is to help companies enhance their discussions of *how* they arrived at the particular levels and forms of compensation that they chose to award to their named executive officers and *why* they pay that compensation, giving investors an *analysis* of the results of their compensation decisions. Comments on the CD&A included:

- ***Compensation philosophies and decision mechanics.*** The staff asked a significant number of companies to discuss the extent to which the amounts paid or awarded under each compensation element affected the decisions they made regarding amounts they paid or awarded under other compensation elements.
- ***Differences in compensation policies and decisions.*** Where a company's disclosure, including that in the Summary Compensation Table, led the staff to believe that the company's policies and decisions for individual named executive officers may be materially different, the staff reminded the company that the CD&A should identify material differences in compensation policies and decisions for individual named executive officers where appropriate.
- ***Performance targets.*** The staff issued more comments regarding performance targets than any other disclosure topic. The staff found that a substantial number of companies alluded to using, or disclosed that they used, corporate and individual performance targets to set compensation policies and make compensation decisions. Corporate performance targets ranged from financial targets such

as earnings per share, EBITDA, and growth in net sales, to operational or strategic goals such as increases in market share or targets specific to a particular division or business unit. Most companies reviewed disclosed that their compensation committees considered individual performance in making executive compensation decisions, although few companies disclosed how they analyzed individual performance or whether they focused on specific individual performance goals as part of that analysis. The staff often found it difficult to understand how companies used these performance targets or considered qualitative individual performance to set compensation policies and make compensation decisions. In making these comments, the staff does not seek to require companies to defend what may properly be subjective assessments in terms of purely objective or quantitative criteria, but rather only to clearly lay out the way that qualitative inputs are ultimately translated into objective pay determinations.

Where it appeared that performance targets were material to a company's policy and decision-making processes and the company did not disclose those targets, the staff asked it to disclose the targets or to demonstrate that disclosure of the particular targets could cause it competitive harm.² The staff reminded companies of Instruction 4 to Item 402(b) of Regulation S-K, which requires companies to discuss how difficult it will be for the executive or how likely it will be for the company to achieve undisclosed target levels or other factors. Where a company omitted a performance target amount but discussed how difficult or likely it would be for the company or individual to achieve that target, the staff frequently sought more specific disclosure that would enhance investor understanding of the difficulty or likelihood.

Where a company's disclosure implied that its current or prior year targets were material to an understanding of a named executive officer's compensation for the last fiscal year or were otherwise material in the context of its CD&A, consistent with Instruction 2 to Item 402(b) of Regulation S-K, the staff asked it to disclose prior year and current year targets. The staff noted that it also may be material for a company to disclose whether the company or the named

executive officer achieved or failed to achieve targets in prior years. Those situations may include, for example, where a company has a multiple year compensation plan or where target levels vary materially between years.

- **Benchmarks.** The staff issued a number of comments asking for a more detailed explanation of how companies used comparative compensation information and how that comparison affected compensation decisions. Where a company stated that it benchmarked its compensation, but it retained discretion to benchmark to a different point or range, or to not benchmark at all, the staff asked it to disclose the nature and extent of that discretion and whether or how it exercised that discretion. Where a company indicated that it benchmarked compensation to its peers, but did not identify the peers or provide sufficient details, the staff asked it to identify the companies to which it compared itself as well as the compensation components it used in that comparison.
- **Change-in-control and termination arrangements.** The staff asked a number of companies to disclose why they structured the material terms and payment provisions in their change-in-control and termination arrangements as they did. Companies were also asked to discuss how potential payments and benefits under these arrangements may have influenced their decisions regarding other compensation elements.

Executive and Director Compensation Tables

Overall, the staff issued relatively few comments to companies on this area of their disclosure. If it appeared that a company made undisclosed assumptions in valuing option awards, the staff asked it to disclose those assumptions in the footnotes to the required table or provide an appropriate cross-reference to the discussion of the assumptions elsewhere in the company's filing. In the Grants of Plan-Based Awards table, where it appeared that a company did not disclose each grant of an award made to a named executive officer in the last completed fiscal year under any plan, the staff asked it to do so. Finally, where a company did not disclose the vesting dates of options, shares of stock, and equity incentive plan awards held at fiscal-year end by footnote to the applicable column in its Outstanding Equity Awards at Fiscal Year-End table, it was asked to do so.

² Companies that believe their explanation to the staff should receive confidential treatment should determine whether requesting confidential treatment pursuant to Rule 83 is appropriate.

Compensation Committee Report

Some companies failed to indicate whether the compensation committee reviewed and discussed the CD&A with management. The staff asked these companies to revise their future reports to include all required information.

Related Person Transaction Disclosure

The staff issued relatively few comments on related person transaction disclosure. However, the staff asked a number of companies to provide a statement that their policies and procedures for review, approval, or ratification of related person transactions are in writing and, if not, to explain how they evidence their policies and procedures.

Corporate Governance

The staff's comments on corporate governance matters primarily focused on who was involved in making compensation decisions. Where a company's disclosure was unclear about exactly who made the compensation decisions, the staff asked for clarification. Where a company indicated that its principal executive officer had a role in the compensation decision-making process, the staff asked the company to describe his or her role. The staff asked companies to disclose the role compensation consultants played in the decision-making process, including the nature and scope of a consultant's assignment and material instructions the company gave it.

STAFF COMMENTS ON THE UPCOMING PROXY SEASON

In an October 9, 2007 speech entitled "Where's the Analysis?,"³ John White, Director of the SEC's Division of Corporation Finance, shared his views on where the first-year disclosures by issuers under the new executive compensation rules have realized the Commission's goal of providing a "clearer and more complete picture of compensation" and where they have fallen short. He emphasized that far too often, meaningful analysis is missing. Mr. White suggested that in the upcoming proxy season, issuers should not merely mark-up this year's disclosure, but should step back and ask the following important questions:

- What is material to my shareholders, to my investors, as they examine the compensation of our executives and

make their voting decisions for our board of directors and investment decisions with respect to our company?

- What are the material elements of individual executive and corporate performance that are considered in setting executive compensation?
- What is the relationship between the objectives of our compensation program and the different elements of compensation?
- What are the material factors that relate to our compensation decision-making process?

CONCLUSION

Although there was nothing all that new or surprising in the staff's report, the staff's guidance helps round out the picture of what the staff was looking for when it issued executive compensation comments. The staff's review of the 350 companies is ongoing. The staff states that it will post the correspondence containing staff comments and company responses to staff comments on the SEC's EDGAR system not less than 45 days after it completes each review. Companies should continue to monitor the SEC website for future interpretive guidance in the executive compensation area and the posting of staff comment letters and issuer responses.

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

Steven Kaplan
+1 202.942.5998
Steven.Kaplan@aporter.com

Richard E. Baltz
+1 202.942.5124
Richard.Baltz@aporter.com

Laura Badian*
+1 202.942.6302
Laura.Badian@aporter.com

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3 Mr. White spoke at a conference sponsored by TheCorporateCounsel.net, CompensationStandards.com, and the National Association of Stock Plan Professionals (NASPP).