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SECURITIES UPDATE

Considerations for 2008 Compensation Disclosure

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Public companies preparing their third year of executive compensation disclosure under the relatively new Securities and Exchange Commission (SEC) requirements are doing so in an environment where executive compensation has become an important and very visible component of federal government bailout programs. In addition, SEC guidance exists based on its experiences reviewing two years of executive compensation disclosure. Companies should consider the impact of these developments and interpretations on their annual executive compensation disclosure, particularly with respect to drafting the Compensation Discussion and Analysis (CD&A).

EESA-Related Considerations

The executive compensation provisions of the Emergency Economic Stabilization Act of 2008 and related regulations (EESA), as a technical matter, apply only to companies that are participating in EESA programs. However, those provisions, and the political dynamics giving rise to them, are shaping the conversations about current and future executive compensation and associated disclosure, even for non-participating companies. To the extent that EESA compensation requirements influence the deliberations and the actions of a compensation committee, those principles need to be described in the CD&A.

For example, financial institutions participating in EESA's capital purchase program must not use compensation incentives that encourage senior executive officers to take unnecessary and excessive risks that threaten the value of the institutions. The regulations issued by the Department of Treasury require that the compensation committees of these participating institutions meet annually with the senior risk officers of the company to be sure that incentive compensation does not encourage such risk, with a certification in the CD&A that such a review has been completed. To the extent that limiting incentives to take excessive risk is now part of the compensation landscape, compensation committees of public companies, whether or not they are EESA participants, may consider it advisable to perform risk analysis of this nature. If compensation committees take risk into account when establishing compensation, that fact must be disclosed in the CD&A. As John White, Director of the SEC's Division of Corporation Finance, said in a speech this fall:

> Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target — with risk, in this case, being viewed in the context of the enterprise as a whole?… [T]o the extent that such considerations are or become a material part of a company's compensation policies or decisions, a company would be required to discuss them as part of its CD&A, available at http://www.sec.gov/news/speech/2008/spch102108jww.htm.

EESA also addresses clawback policies to recover bonus compensation that is based on materially inaccurate financial statements, limitations on severance payments to senior executive and limitations on deductions on federal income tax deductions for compensation paid to senior executive officers. While many companies already address these topics in their CD&A, the publicity surrounding the EESA requirements makes it prudent for public companies, even non-EESA participants, to review and expand their explanations and analyses of these subjects.

CD&A Generally

The CD&A is intended as the centerpiece of a public company's executive compensation disclosure. As such, it merits careful consideration and should be updated each year to reflect the principles that the compensation committee applied when setting compensation decisions for that year. To the extent that current market conditions have affected, or are anticipated to affect, compensation decisions, that needs to be explained and analyzed. This is in addition to the influence, if any, of specific EESA requirements. For example, if stock performance conditions to existing awards have been waived, or if stock performance measures are being applied differently either for year-end 2008 or future awards, the waivers or changes should be explained in the CD&A. If a compensation committee changes the way it allocates incentive compensation between cash and equity awards in light of current market conditions, or for any other reason, the CD&A should discuss the rationale for the new approach. If additional retirement programs are established for named executive officers in response to lowered retirement accounts caused by the unprecedented stock market decline, the CD&A should explain the reasons why such action was taken.

In October 2007, the SEC staff issued a report based on its review of the first year of disclosure for 350 companies under the revised SEC compensation rules, available at http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm. A principal theme of this report was that the SEC staff wants the CD&A to focus on how and why a company arrives at specific executive compensation decisions and policies. The summary of comments described in the October 2007 report is still relevant today. Re-reading this report before drafting 2008 executive compensation disclosure provides a good refresher as to what the SEC is seeking with respect to the CD&A disclosure.

In the speech quoted above, John White highlighted the three most commented upon aspects of the CD&A in SEC review:

- Analysis,
- Performance targets, and
- Benchmarking.

Companies preparing their 2008 CD&A should be responsive to the concerns that the SEC has raised in each of these areas.

Analysis. According to John White, the SEC staff, in its second year of reviewing CD&A disclosure, commented heavily on the need for companies to provide more analysis with respect to:

- The material elements of their compensation;
- How they arrive at the varying levels of compensation; and
- Why they believe their compensation practices and decisions fit within their overall objectives and philosophy.

The SEC staff, in its comment process, has been encouraging companies to provide explanations for each of the specific factors that their compensation committees considered to be material when approving particular components of compensation, and to place those decisions in context. The staff has been pushing for analysis of the reasons why the company believes that its specific compensation decisions are appropriate in light of the various factors that the committee considered. The staff also is seeking analysis on how determinations with respect to one element of compensation impacted other compensation decisions and why such decisions were made.

Performance Targets. Many of the comments that the SEC issued on executive compensation during the last year related to performance targets. When the CD&A discloses that performance targets were used in setting compensation but does not disclose the target levels, the SEC staff asks the company to justify the omission and provide a legal analysis of the reasons why the company believes that disclosure would result in competitive harm, which is the only basis for omission of performance targets that are material to compensation decisions. If a company determines that it is not required to provide quantitative goals, it should clearly explain how qualitative judgments on performance result in payment decisions. Additionally, the company must include a discussion of how difficult the performance targets are to achieve.

Benchmarking. If a company sets a material element of compensation through benchmarking, the CD&A must identify the peer group used for this purpose and explain the basis for the compensation committee's selection of this peer group. In addition, the CD&A must discuss how the benchmarked data were used, as well as the relationship of the data to the actual compensation granted. This detailed benchmarking disclosure is important for providing investors with an understanding of the extent to which the company is setting compensation to remain competitive with a peer group.

Compliance & Disclosure Interpretations

In July 2008, the Division of Corporation Finance consolidated various interpretations of Regulation S-K into a single set of Compliance & Disclosure Interpretations of Regulation S-K, including issues concerning tabular and narrative executive compensation disclosure that appear in proxy statements, available at http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm. Many of the interpretations appearing in this guidance remain unchanged from the prior telephone interpretations that the SEC staff has published. However, there are some modified positions and some new interpretations. Therefore, it is useful to consult this consolidated collection of SEC guidance when preparing proxy disclosure for the upcoming proxy season.

For example,

- Question 118.05 clarifies that for the purpose of preparing CD&A disclosure, compensation benchmarking generally entails using compensation data about other companies as a reference point from which to base, justify or provide a framework for a compensation decision, rather than considering a broad-based third-party survey to obtain a general understanding of current compensation practices.
- Question 118.06 specifies that the role a compensation consultant plays in determining or recommending the amount or form of executive and director compensation is to be disclosed as part of the compensation committee disclosure. If the consultant plays a material role in compensation-setting practices and decisions, that role must be discussed in the CD&A.
- Question 119.07 specifies if an executive officer has fully reimbursed the company for any item, that item is not considered a perquisite or other personal benefit and does not need to be separately identified by type. It is important to note that full reimbursement may likely be different from incremental cost in determining the value of a perquisite for disclosure purposes.
- Question 119.12 addresses the determination of who should be included as the named executive officers for the last completed fiscal year where there has been a reversal of previously expensed equity awards. If a previously expensed amount would have been reported in the summary compensation table had the executive been included in that table during the year in which the award was expensed, the reversal of that expense may be considered in determining whether such executive officer is a named executive officer.
- Question 119.15 addresses the disclosure of assumptions made in the valuation of

stock and option awards in the summary compensation table by reference to a discussion of those assumptions in the registrant's financial statements, footnotes and Management's Discussion and Analysis, specifying that it is not sufficient to reference financial statements (or associated footnotes) that contain only assumptions for the company's grants during the most recent fiscal year if awards granted in prior fiscal years were recognized during the most recent fiscal year.

The above is not intended as a summary of all new and revised positions taken by the SEC staff in the Compliance & Disclosure Interpretations, but as a reminder of the importance of this resource to resolve questions that arise when preparing compensation disclosure.

If you have any questions regarding executive compensation disclosure, please contact the author of this Securities Update, Laura D. Richman, at +1 312 701 7304 or any of the lawyers listed below or any other member of our Corporate & Securities group.

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