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A legal update from Dechert's Employee Benefits and Executive Compensation and Corporate and Securities Groups

SEC Observations on 2007 Executive Compensation Disclosures

On October 9, 2007, the SEC's Division of Corporation Finance released its much-awaited report, based on its review of 2007 executive compensation disclosures in 350 proxy statements filed by public companies. On the same day, the SEC's Director of the Division of Corporation Finance, John White, was the keynote speaker at the 2nd Annual Proxy Disclosure conference. This *DechertOnPoint* update summarizes the report and Mr. White's observations.

Overview

Mr. White acknowledged the difficulty companies faced in complying with the new executive compensation disclosure rules and suggested that the SEC comment letters responding to the 350 proxy statements and report are intended to guide future filings. While a wealth of information has been made available to shareholders, and the 2007 proxy season produced the most comprehensive disclosure ever, Mr. White stated his belief that there is more work to be done and that companies must take the SEC's guidance to heart. Future comments on executive compensation disclosure will reflect the SEC's expectations expressed in the comment letters and the report.

Summary of SEC Report

The SEC report summarizes the principal areas covered in the comment letters and suggests where additional and clearer disclosure should be provided.

As Mr. White previewed in his speech on September 26 (see *DechertOnPoint* [October 2007/Special Alert](#)), the report focused on two

principal themes that emerged from the SEC's review:

- The manner of presentation matters. Disclosure should be in plain English, clear and concise and organized in a way that helps the reader understand the company's disclosure.
- The Compensation Discussion & Analysis section (CD&A) must focus on how and why a company arrives at specific executive compensation decisions and policies. The CD&A should help the reader understand the basis and context for providing different types and amounts of executive compensation.

Manner of Presentation

Comments regarding manner of presentation focused on prioritizing material information, formatting concerns, and guidance regarding clarity of expression.

Material information should be emphasized appropriately. A significant number of comments addressed emphasizing material information and de-emphasizing less important information. For example, companies were asked to focus on how and why they established levels of compensation and to shorten lengthy discussions of compensation program mechanics.

Disclosure should be ordered according to the final rules. Several companies were asked to place the CD&A before the tabular disclosure in future filings as required by the final rules. The SEC report notes that additional charts, tables, and graphs were generally helpful, particularly tables demonstrating the amounts of change-in-control and severance payments available to

named executive officers. However, where additional tables calculated compensation differently from required tables or were otherwise confusing, companies were asked to de-emphasize supplemental tables. In particular, the SEC requested that companies state that alternative summary compensation tables are not substitutes for required tabular disclosure and, if provided, companies were asked to explain differences between amounts reported in required and supplemental tables.

Clear and concise disclosure is required by plain English rules. Companies must follow the drafting principles presented in Exchange Act Rules 13a-20 and 15d-20, containing the plain English requirements, while maintaining the focus on required disclosure items. Although a significant number of companies were asked to explain how and why compensation decisions are made, the SEC believes that, with careful drafting, disclosure may be shorter and more concise. In addition, companies were asked to replace boilerplate discussions with specific analysis, for example, explaining how individual executive performance is considered in setting compensation rather than simply stating that the compensation committee makes subjective determinations of individual performance.

CD&A Comments

Generally, companies were advised to follow the principles-based disclosure regime required by the final rules and focus on material factors underlying policies and decisions behind information provided in the tables. The report notes that the 15 examples provided in the final rules are not exhaustive or mandatory and that each company must assess its own facts and circumstances to determine what information is material. In particular, companies were asked to focus in the CD&A on how and why compensation decisions are made rather than provide lengthy descriptions of compensation philosophies and mechanics.

Performance targets. By far the most comments related to disclosure of performance targets. The SEC requested that companies clearly lay out the manner in which performance achievement is measured and translated into the determination of compensation, regardless of whether such performance may be objectively measured. If a company determines that performance targets are not required to be disclosed due to the possibility of competitive harm, the SEC will

require compliance with the alternative disclosure rule, which provides that the company must explain the likelihood that targets will be attained. In addition, where non-GAAP performance measures were presented, the SEC will require companies to explain how they calculate those measures.

Benchmarks. If companies indicated the use of benchmarking techniques, the SEC will require them to identify the benchmark and, if applicable, its components (including component companies). If a company retains the discretion to determine the range or point at which the company benchmarks compensation or to disregard the results of benchmarking, the SEC requested a discussion of the nature and extent of such discretion and whether and how it was exercised. Finally, specific description of where companies fell in the benchmarking range was requested of some companies.

Use of analytic tools. Where companies indicated they used analytic tools such as tally sheets, wealth accumulation reports, benchmarking, and consultant advice to determine appropriate compensation levels, the SEC frequently asked them to explain what the tools were (e.g., by describing their content), what information was obtained through the use of the applicable tools, and how that information affected compensation decisions.

Interrelationship between compensation elements. A significant number of companies were asked by the SEC to explain the interrelations between compensation elements and how amounts paid or awarded with respect to one element affected amounts paid or awarded for other elements.

Material differences in compensation. Where the SEC perceived significant differences in compensation policies among named executive officers, companies were asked to explain those material differences.

Prior year or current year compensation. The SEC reiterated that prior or current year compensation matters should be discussed in the CD&A if necessary to understand current year compensation. Situations where such matters should be discussed include, for example, multiple year compensation plans or material variations between performance targets from year to year.

Change in control or termination arrangements. The SEC asked a significant number of companies to explain how and why the material terms and payment provisions of change-in-control and termination arrangements were determined and how they fit into overall compensation objectives and affect decisions regarding other elements of compensation.

Other Comments

Equity-based awards. The SEC asked a number of companies to provide footnote explanation of the assumptions used in valuing option awards and to detail the vesting dates of options, stock awards, and equity incentive plan awards held at fiscal year end.

Related-person transactions. The SEC requested numerous companies to state whether they had written policies and procedures for the review, approval, or ratification of related-person transactions and, if not,

to explain how such policies or procedures are evidenced.

Corporate governance. Comments from the SEC on corporate governance focused predominantly on the identity of decision-makers, including the role and scope of involvement of compensation consultants and executive officers in the decision-making process.

Next Steps

It is not too early to begin preparing for your company's 2008 proxy statement. Advance planning will save time later and allow your company to evaluate its compensation processes in a manner responsive to the SEC's comments. This is particularly important to consider prior to making critical year-end compensation decisions regarding bonuses, equity or other performance grants.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at

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