

SEC UPDATES GUIDANCE ON EXECUTIVE COMPENSATION DISCLOSURE

The Securities and Exchange Commission (SEC) has updated its interpretive guidance on the executive compensation disclosure required by Item 402 of Regulation S-K, in the form of both new and revised Q&A-based compliance disclosure interpretations (CDIs). (These CDIs may be found at <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>.) The updated guidance deals with a few hot-button items, along with a variety of other substantive and technical issues. Among the many issues discussed, three seemed to be generally applicable to most registrants. These, along with the other disclosure issues, are discussed in greater detail below.

- *Performance Targets* – The SEC has attempted to lay out a bright-line test for determining whether a registrant must disclose performance targets. The first part of the test requires an assessment of the materiality of such performance targets in relation to the compensation program. The second part requires an analysis of whether (1) the targets involve confidential trade secrets or commercial or financial information, and (2) disclosure would result in competitive harm to the registrant. To the extent performance targets are material, they must be disclosed unless both prongs of the confidentiality/competitive harm analysis can be satisfied.
- *Benchmarking* – The SEC has defined the concept of “benchmarking” broadly to include not only precise targeting of peer group compensation, but also mere justification of an overall compensation framework. To the extent benchmarking, as so broadly defined, is a material component of a registrant’s compensation-setting process, a thorough discussion and analysis of such benchmarking must be included in the Compensation Discussion and Analysis (CD&A).
- *Reversal of FAS 123(R) Expenses* – The SEC has provided guidance on when a registrant is required to take into account the effect of the reversal of a prior FAS 123(R) expense for stock-based compensation for an executive officer with respect to which the expense was never disclosed because such executive officer was not previously a named executive officer. The SEC clarified that registrants must recognize such reversal for purposes of determining the three most highly paid executive officers in the same manner as for other named executive officers, regardless of whether the executive officer in question was a named executive officer in the year the applicable expense was previously recognized.

Performance Targets. Much has been made of the requirement to disclose performance targets related to executive compensation, which disclosure remains a sensitive issue for most registrants. The disclosure requirement has been clouded by ambiguous language in the regulations, coupled with a dearth of clear guidance from the SEC. While formal and informal SEC guidance has confirmed that targets must be disclosed in the CD&A in certain circumstances, precise guidance as to which circumstances require such disclosure, or alternatively, permit a registrant to omit such disclosure, has been inadequate at best.

In this update, the SEC presents a two-pronged analysis for determining whether performance targets must be disclosed. The first prong is simply the same threshold question applicable to all executive compensation disclosure in the CD&A, the answer to which depends upon the facts and circumstances and requires a good-faith evaluation by the registrant: Are the performance targets material in the context of the registrant's executive compensation policies or decisions? If the targets are not material in this context, no disclosure is required. However, if the first prong is satisfied, the second prong of the analysis requires a two-part determination of (1) whether the targets involve confidential trade secrets or confidential commercial or financial information, *and* (2) whether disclosure would result in competitive harm to the registrant. Where the answer to *either* part of the second prong is negative, the targets must be disclosed. Thus, material performance targets may be omitted from the CD&A *only* if the targets are confidential and disclosure would result in competitive harm. The SEC also clarified that the existence of competitive harm turns on whether a competitor or contractual counterparty could extract information from the disclosure regarding the registrant's business or business strategy and use it to the registrant's detriment. The guidance refers to the competitive harm standards developed through case law and cites several cases for reference.

The SEC reminds registrants that because the CD&A will be subject to staff review, a company may be required to demonstrate that nondisclosure of performance targets meets the confidential treatment/competitive harm standard, and that disclosure will be required if the standard is not met. Thus, registrants that fail to meet this standard could be required to refile their proxies and annual reports. Finally, the SEC reiterated that where material performance targets are properly omitted based on a reasoned finding of confidentiality and competitive harm, the CD&A must nonetheless discuss how difficult or likely it will be for the undisclosed target level to be achieved.

With respect to disclosure of targets, the SEC also recognized a distinction between "qualitative/subjective" individual goals (such as "effective leadership and communication") and "quantitative/objective" goals (such as specific financial metrics), and clarified that when compensation determinations are based on the achievement of goals that are inherently subjective or qualitative assessments, registrants need not discuss quantitative targets where none exist.

Interestingly, the SEC did not take the opportunity in this update to provide further guidance on the issue of whether and when disclosure of the current year's performance targets is required. The disclosure requirement clearly applies to the prior year's compensation decisions, which are the general focus of Section 402 disclosure. However, the final rules allude to, and the SEC has informally acknowledged that there may be, a requirement to disclose the performance targets for the current year (the year during which the proxy statement or 10-K, as applicable, is filed) when necessary for an understanding of some aspect of the prior year's compensation. Just when this requirement arises remains unclear.

Benchmarking. Another hot-button for registrants is the disclosure of benchmarking executive compensation against that of peer companies. Registrants must disclose the practice of benchmarking in their CD&A if it constitutes a material component of their compensation process. The discussion must include the specific benchmark(s) used and, if applicable, the components (including component companies). This update more precisely, and broadly, defines benchmarking as “using compensation data about other companies as a reference point on which—either wholly or in part—to base, justify, or provide a framework for a compensation decision.” As such, disclosure is required where peer companies’ compensation data is used simply to justify an overall compensation framework. Benchmarking does not, however, include the use of broad-based third-party surveys merely for a more general purpose, such as to obtain a general understanding of current compensation practices.

Treatment of Reversed Equity Compensation Expenses in Determination of the Top Three Executive Officers. For the purpose of determining the three most highly paid executive officers of a registrant who will become the registrant’s named executive officers along with its CEO and CFO, an individual’s total compensation includes the amounts attributable to equity awards for which the registrant claimed an accounting expense in the last fiscal year pursuant to FAS 123(R), as required to be reported in the stock and option award columns of the Summary Compensation Table (SCT). For purposes of calculating amounts attributable to an executive officer’s equity awards for a given year’s disclosure, the general rule under the regulations provides that when an expense that was previously disclosed is reversed under FAS 123(R) because, for example, awards were forfeited or performance-based vesting conditions were not achieved, the reversal must be reflected in the executive officer’s compensation for the year of reversal. As explained in prior guidance, such reversal should be reflected in the amounts disclosed only to the extent that the previously expensed portions of the stock or option awards were actually disclosed in the SCT in prior years. This raised the question of whether reversals for executives who had not appeared in the SCT in such prior years, and for whom such expenses had never been disclosed, must be taken into account when calculating the total compensation for determining a registrant’s three most highly paid executive officers. The SEC has clarified that, regardless of when and if an executive has previously appeared in the SCT, all amounts reversed under FAS 123(R) during the last completed fiscal year should be considered to the same extent that they would be considered for named executive officers who had appeared in the SCT in prior years, even though such amounts being reversed for a particular executive were not previously disclosed as compensation for such executive.

Compensation Consultants. Item 407(e)(3)(ii) of Regulation S-K (relating to the status and authority of a registrant’s compensation committee) specifically requires a discussion of the role of compensation consultants in setting executive and director compensation. Item 402(b) of Regulation S-K (the CD&A) requires a discussion of the policies and processes that are material to a registrant’s executive compensation-setting process, which may in some cases require a discussion of the involvement of one or more compensation consultants. Heretofore, many registrants found it difficult to square these two sections. The SEC sought to clarify this, emphasizing that *any role* of a compensation consultant in determining executive and director compensation must be provided as part of a company’s Item 407(e)(3)(ii) disclosure, whereas discussion is required as part of the CD&A only where the compensation consultant plays a material role in the registrant’s compensation-setting practices. However, in order to avoid

duplication of compensation committee disclosure and to make the disclosure more coherent, many registrants have intentionally chosen to combine the two requirements in the CD&A. Thus, while a registrant may choose to relegate the discussion of a consultant's *immaterial* role to a separate section that specifically deals with the compensation committee, it may be more logical to discuss the compensation committee and its role in setting executive compensation, along with the discussion of any role played by a compensation consultant, as part of the CD&A.

Perquisites. Where the aggregate value of all perquisites and personal benefits paid to a named executive officer in a given fiscal year exceeds \$10,000, each item, regardless of the cost to the registrant, must be identified by type in a footnote to the "All Other Compensation" column of the SCT. Thus, even if a perk has no "aggregate incremental cost" to the registrant, it must be identified if the \$10,000 threshold is otherwise met. The SEC has now clarified, however, that where an executive has fully reimbursed the registrant for any cost incurred, such reimbursed cost, by definition, does not represent a perquisite or personal benefit, and need not be identified or otherwise disclosed. This revises a prior position that seemed to indicate that, in order to be excluded from the definition of perquisite or personal benefit, the actual cost and *all related costs* had to be fully reimbursed.

Equity Compensation. The SEC supplemented its formal guidance on disclosure of equity compensation in two areas: disclosure of valuation assumptions used to determine the fair value of an equity award and disclosure of equity-award vesting dates.

Registrants are required to disclose the assumptions made in valuing equity awards listed in the SCT. This can be accomplished by reference to a discussion of those assumptions in the registrant's financial statements or footnotes thereto, or to a discussion in the Management's Discussion and Analysis section. Because the SCT disclosure of stock and option awards for a given year equals the FAS 123(R) dollar amount recognized for financial reporting purposes in such year with respect to outstanding awards, the dollar amount disclosed for any year may relate to awards granted over the course of several years. As such, the SEC clarified that the required valuation disclosure may need to reference the financials for multiple years and not simply the most recent year.

The SEC also acknowledged that where a registrant chooses to disclose the valuation assumption relating to awards granted in the immediately prior fiscal year in connection with the Grants of Plan-Based Awards table (although there is no such requirement for this table), the SCT disclosure requirement for awards granted in such year may be satisfied by making reference to such disclosure made in connection with the Grants of Plan-Based Awards table.

The vesting dates for equity awards reported in the Outstanding Equity Awards at Fiscal-Year-End table are required to be reported in a footnote to the table. For registrants whose named executive officers have multiple equity awards over many years, this requirement can make for lengthy footnote disclosure. The SEC has clarified that the disclosure requirement may be satisfied by adding an additional column to such table showing the grant date of each award and including in a footnote a statement of the standard vesting schedule that applies to all awards. Of course, any vesting schedule that differs from the standard vesting schedule would also have to be disclosed.

Nonqualified Deferred Compensation. The SEC confirmed two points related to the disclosure of nonqualified deferred compensation. First, the information required to be disclosed with respect to each nonqualified deferred compensation arrangement must be separately identified on a plan-by-plan basis. Second, where company contributions earned in a given year under an “excess” plan related to a qualified plan are not credited to an executive’s account until the following year, such contributions are nonetheless required to be disclosed in the Registrant Contributions in Last FY column of the Nonqualified Deferred Compensation table for the year in which such contributions were earned.

Summary Compensation Table Footnote Disclosure. Where the regulations do not specifically limit required footnote disclosure to the registrant’s last fiscal year, footnote disclosure for prior years being reported is required only to the extent that it is material to an investor’s understanding of the compensation disclosed in the SCT for the registrant’s last fiscal year.

Cash Compensation Subject to Forfeiture in a Future Year. A cash award subject to forfeiture in a future year, such as a retention bonus granted in Year 1 to be paid in Year 3, subject to the executive’s continued employment through the payment date, should not be disclosed in the SCT until the year in which it is actually earned (Year 3). The retention bonus arrangement, however, should be discussed in the CD&A in Years 1 and 2.

Parent-Subsidiary Disclosure. The SEC has provided some further guidance on the treatment of compensation paid to an executive who provides services for more than one reporting company in a parent-subsidiary chain.

As noted in prior guidance, where nearly 100% of an executive’s time is spent working for a subsidiary, but the executive is paid by the parent, the compensation paid by the parent needs to be disclosed in the subsidiary’s executive compensation tables. However, where the executive’s time is split between the parent and the subsidiary such that it would be necessary to allocate the amounts paid by the parent, the SEC has clarified that the payments *allocable to services* to the parent need not be reflected in the subsidiary’s tables. The prior SEC guidance could have been interpreted to exclude from the subsidiary’s disclosure all payments *made by* the parent.

Finally, the SEC presented a new hypothetical example, based on very specific facts and circumstances, stating that where amounts are actually paid by a parent, regardless of the allocation, such amounts must nonetheless be disclosed in the parent’s tables and taken into account when determining the parent’s three most highly compensated executives. Furthermore, both the parent’s and the subsidiary’s SCTs should contain appropriate footnote disclosure reporting the extent to which the same compensation is reported in both tables. It is unclear how this new example would apply to different facts and circumstances.

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