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CLIENT MEMORANDUM

THE SECURITIES AND EXCHANGE COMMISSION RELEASES REPORT ON EXECUTIVE COMPENSATION DISCLOSURE – THINGS TO CONSIDER FOR THE 2008 PROXY SEASON

In 2006, the Securities and Exchange Commission (the "SEC") adopted dramatic changes to the disclosure requirements for executive and director compensation in proxy statements and other SEC filings. The changes represented a major revision of those disclosure requirements and were "intended to provide investors with a clearer and more complete picture of compensation" of executives and directors by forcing companies to examine their compensation practices in order to explain to shareholders the underlying reasons for awarding both the types and amounts of compensation.

At the completion of the first proxy season following adoption of these new rules, the reviews were mixed. In some instances, companies took the message to heart, thoroughly scrubbing their compensation practices to understand not only what was being granted but also why particular types of compensation were granted in light of a stated compensation philosophy. However, in many instances, critics felt the disclosure was inadequate, claiming compensation philosophies remained somewhat boilerplate (e.g., "our philosophy is to pay compensation necessary to attract and retain the talented individuals required to run our business"), and that even when compensation philosophies appeared genuine, the type and amount of compensation actually paid did not seem to tie to the stated philosophy, or that there was little or no disclosure explaining how compensation decisions actually squared with (or departed from) the philosophy, as required by the new rules.

Following the 2007 proxy season, the Staff of the Division of Corporation Finance of the SEC (the "Staff") undertook a review of 350 public companies of varying size and industry mix in order to evaluate compliance with the new rules. In late August and late September, the SEC issued comment letters to certain companies, identifying perceived problems with their compensation disclosure. The SEC indicated that comment letters were generally intended to provide guidance to companies with respect to future filings and we believe that few, if any, companies will be required to amend and restate their 2007 proxy disclosure.

Based on its review, on October 9, 2007, the Staff issued a report detailing its observations of executive compensation disclosure under the new rules. In connection with the release of the report, John W. White, the Director of the Division of Corporation Finance, gave a speech outlining the Staff's findings. In many instances, the review echoed what many critics had already stated – that disclosure was in some respects inadequate and lacked the proper analysis required by the new rules. As a result, many companies may find that simply supplementing their 2007 proxy disclosure for future filings will not be sufficient to address the Staff's concerns, and that, in particular with respect to Compensation Discussion and Analysis, a "clean slate" process might prove necessary.

The Staff Report

In its report, the Staff focused on two items: analysis and presentation.

Analysis

With respect to analysis, much of the Staff's comments focus on the Compensation Discussion and Analysis of the disclosure, where the Staff indicated such disclosure "needs to be focused on *how* and *why* a company arrives at specific executive compensation decisions and policies." It is the Staff's belief that the Compensation Discussion and Analysis needs to have more meaningful analysis, a point that John White emphasized in his speech, stating, "far too often meaningful analysis is missing – this is the biggest shortcoming of the first-year disclosures." The Staff observed that many companies provided significant disclosure on the mechanics of the compensation process but failed to discuss how or why the process resulted in the compensation actually paid. The Staff stressed that analysis should include both how companies arrived at decisions relating to particular levels and forms of compensation as well as why such compensation was paid. Some remedies suggested by the Staff include:

- Presenting the substance of the compensation decisions, including how the relevant information was analyzed and why this analysis resulted in the compensation decision. For example, in lieu of lengthy discussion about compensation philosophies, the disclosure should explain how and why those philosophies resulted in the numbers presented in the required tables, and in lieu of lengthy discussion about the compensation committee's decision-making process, the disclosure should explain how the committee's analysis of relevant information resulted in the decisions it made.
- Providing discussion of whether determinations made with regard to one compensation element might or might not have influenced decisions made with respect to other compensation elements contemplated or awarded. For example, where tally sheets were used, the disclosure should explain the information contained on the tally sheet and how the information was used in making current compensation decisions.
- Identifying material differences in the compensation policies and decisions applied to specific named executive officers.
- Clarifying how performance targets were used or how qualitative individual performance was considered in setting compensation policies and making compensation decisions.
- Where individual performance targets were used, discussing how individual performance was analyzed and whether or not specific individual goals were considered.

- When benchmarking, specifically identifying the benchmark, as well as component companies,[1] and providing a more detailed explanation of how comparative compensation information was used and how that comparison affected compensation decisions. The Staff has noted, however, that if benchmarking was used for informational purposes rather than for developing specific target compensation, less information might be required.
- Explaining why the material terms and payment provisions in change-in-control and termination arrangements are structured in that manner (e.g., why severance is paid on a single trigger rather than a double trigger), and discussing how potential payments and benefits under these arrangements might have influenced decisions regarding other compensation elements.

The report also specifically addresses the Staff's view with respect to disclosure of performance targets, a topic that received much debate during the 2007 proxy season, as many companies chose not to disclose actual targets, relying on a confidentiality exception based on "competitive harm." The Staff continues to believe that disclosure of actual performance targets is required when material to the compensation policies and decision-making process, and noted in the report that it issued more comments relating to performance targets than any other disclosure topic. To the extent that companies continue to believe such disclosure would result in competitive harm, such companies will need to be prepared to defend such assertion. Even if confidentiality treatment is accepted, the Staff expects an issuer to discuss how difficult the performance targets are to achieve with some level of specificity. Informally, the Staff has indicated that more than 50% of the Fortune 100 companies fell short of the required disclosure of targets. We expect that this will be an area of increased Staff attention next year.

Notwithstanding the above suggestions, John White specifically noted that disclosure is required only when material to the determination of compensation, confirming the SEC's view that materiality tests applicable generally to disclosure under the Federal securities laws apply in the case of compensation disclosure. Thus, whether any particular disclosure or analysis is required will depend, in part, on whether the matter is in fact material.

Presentation

The Staff also focused on the manner in which the disclosure was presented, stating, "the manner of presentation matters — in particular, using plain English and organizing tabular and graphical information in a way that helps the reader understand a company's disclosure" is required. Some areas of improvement suggested by the Staff include:

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[1] Difficult issues arise when the benchmarking involves numerous companies (e.g., 200) in a consultant's survey report.

- Writing disclosure in plain English in a manner that is clear and understandable to investors.
- Presenting material information, such as descriptions of how and why compensation is established, more prominently, and shortening and de-emphasizing less important information, such as compensation program mechanics.
- Avoiding the use of, or de-emphasizing, alternative tables that might overshadow the required tabular disclosure.

Suggestions for the 2008 Proxy Season

The 2008 proxy season is just around the corner and, as the Staff report implies, there is much room for improvement. For many companies there will be a significant amount of work required to create disclosure that better fits with the Staff's views, and with the first proxy season under its belt, companies should expect the Staff's review of 2008 proxies to be more stringent. As noted by John White, the Staff is expecting results from the SEC's "call for more and better analysis and clearer, more concise disclosure," and this will require significant thought and effort on the part of those drafting the proxy disclosure. The question, of course, is how best to implement these changes, which companies spent significant time last season drafting. Here are some suggestions for 2008.

- Start Early. Given the Staff's request for more analysis, a defined process will be essential to gathering the necessary information and translating this information to clear and concise analysis.
- Get the Compensation Committee More Involved. In 2007, many companies found themselves initially guessing at the elements considered by their compensation committees and the reasons for their decisions. Actual discussion with committee members often came fairly late in the process. This often led to confusing, if well intended, disclosure. Having an understanding of committee considerations early on will help those whose task it is to translate the information into the compensation story to focus on the material items and their prominence in the disclosure. John White suggested, prior to starting a draft of the Compensation Discussion and Analysis, that companies have every key participant in the compensation process turn in a one-page, bullet-point list reflecting his or her views on the *hows* and *whys* of the compensation-decision process, including "the key analytic tools used by the compensation committee, the findings that emerged from the analysis and the resulting actions taken impacting executive compensation in the last year."
- Start with a Clean Slate. This may be painful, but, in the long run, a clean piece of paper will likely serve most companies better than trying to shoehorn new information into existing disclosure.

- Reconsider Performance Target Disclosure. The Staff specifically questioned the lack of disclosure of performance targets. Take a fresh look at whether performance targets are confidential and whether their disclosure would cause competitive harm. For example, disclosure of EBITDA targets for a prior year will rarely cause competitive harm. Don't confuse the market's potential reaction to such disclosure, which might be a valid concern, with the confidentiality exemption from disclosure.

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If you have any questions about this memorandum, please contact David E. Rubinsky (212-728-8635, drubinsky@willkie.com), J. Pasco Struhs (212-728-8109, pstruhs@willkie.com), or the attorney with whom you regularly work.

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