ALM LAW JOURNAL NEWSLETTERS
The Corporate Compliance & Regulatory Newsletter®
Volume 4, Number 2 • November 2006

Executive Compensation Disclosure

What You Need to Do Now *to Prepare for the New Requirements*

By Thaddeus J. Malik and Jeffrey R. Shuman

On July 26, 2006, the Securities and Exchange Commission (SEC) adopted amendments to its rules relating to the disclosure of executive compensation. Since these new rules apply to SEC filings and reports for fiscal years ending on or after Dec. 15, 2006, public filers who use the calendar year as their fiscal year will be required to comply with the new disclosure requirements when preparing their 2007 proxy statements.

While that leaves several months before the filing and mailing of 2007 proxy materials, there are a number of reasons why it is important for companies to get an early start on revising their proxy disclosure to comply with the new rules. In particular, the new compensation tables and the addition of a Compensation Discussion & Analysis (CD&A) section will require extensive consideration, discussion and drafting by management and the company's Compensation Committee. The SEC has made it clear that boiler-plate disclosure will not suffice when discussing the matters required to be covered by the CD&A section. Rather, the SEC has repeatedly emphasized the need for a principles based approach which describes and analyzes all elements of compensation that are material to an investor's understanding of how the company motivates and compensates its named executive officers.

While a detailed summary of the new rules is beyond the scope of this article, the following suggestions are meant to highlight some steps that companies should consider taking immediately in order to facilitate compliance with the new rules. Companies with fiscal years ending prior to Dec. 15, 2006 should consult the Transition Questions and Answers available from the Division of Corporation Finance section of the SEC's Web site.

First, Verify That Your Disclosure Controls Are Sufficient

As a first step in preparing the 2007 proxy statement, it is important for companies to review their disclosure controls to confirm that they are collecting all of the information that must be considered for disclosure pursuant to the amended rules. While there are a number of steps that can be taken, possibilities include:

- completing the summary compensation tables for the past 2 fiscal years for those persons likely to be NEOs in fiscal 2006 in order to determine what additional information the company will need to collect;
- creating mockups of other newly required tables using compensation information for fiscal 2005 as a means of approximating the additional information that will be required to be collected during fiscal 2006;
- confirming that all performance studies, consultant's reports, board and committee minutes, plans, contracts, policies and other information used in and relating to the determination of NEO compensation are readily accessible to, and have been reviewed by, those individuals responsible for preparing the required disclosure and contain sufficient detail to allow those individuals to engage in meaningful analysis;
- updating tally sheets to encompass all required information (such as all perks in excess of $10,000); and
- confirming that required information is being solicited and collected with respect to all potential NEOs (keeping in mind the changes to the rules for determining NEOs).

Implement Procedures to Facilitate Cooperation

The revised rules will require companies to adopt a multidisciplinary approach to disclosure that will be dependent upon increased cooperation among different core competencies within the organization, and the expansion of the disclosure preparation process beyond the company's legal and human resources departments. For example, the role of accountants and actuaries in the disclosure process will be noticeably increased due, in part, to required disclosure touching on FAS 123R and FAS 106. In some cases, these individuals will be required to draft disclosure based on information they would not otherwise be privy to.

Unless those persons tasked with drafting responsibility are present during the Compensation Committee meetings where compensation decisions are made or have access to the relevant backup and support materials (*ie*, charts and performance studies) and the persons involved in the deliberative process, it will be difficult for them to draft meaningful disclosure explaining and analyzing the reasons for those decisions. Where companies have not previously done so, they should consider having a member of the legal staff present during those Compensation Committee meetings to ensure that appropriate weight is given to the CD&A disclosure requirements and an adequate record is kept of the deliberative process.

Drafting the CD&A Will Be An Iterative Process

Perhaps the most challenging aspect of the new rules will be drafting the new CD&A section. The SEC has indicated that this new section should provide material information and analysis to investors about the methodology underlying the company's compensation decisions and policies in a manner that is meaningful, avoids resorting to boilerplate disclosure and

---

Thaddeus J. Malik, a member of this newsletter's Board of Editors, is a Partner in Jenner & Block's Chicago office. He may be reached at 312-840-7213 or tmalik@jenner.com. **Jeffrey R. Shuman** is an Associate with the firm.

complies with the SEC's rules on plain English disclosure. While some issuers filed a CD&A section with their 2006 proxy statements based on the rules as originally proposed, most issuers will be forced to draft this disclosure from scratch with little in the way of useful precedent. Of course, since every board of directors uses its own criteria in making compensation decisions, every company will need to prepare a unique CD&A section that accurately reflects these criteria and the Compensation Committee's deliberative process.

As a result, companies will have to be careful to build sufficient time into the drafting process to ensure that the CD&A section will receive the appropriate amount of review from the applicable constituencies within the organization. Because the registrant's chief executive officer and chief financial officer will be required to certify the information contained in the CD&A, which is deemed filed with the Commission, senior management has even more of an incentive to focus their attention on the preparation of the CD&A section. Similarly, since the Compensation Committee will be required to include in the Compensation Committee Report its recommendation as to whether the CD&A be included in the proxy statement, the Compensation Committee will also likely focus extra attention on the preparation of the CD&A section. This may necessitate a reexamination of the Compensation Committee calendar to schedule additional meetings to allow the members of the Compensation Committee and the relevant members of management to review iterative drafts of the CD&A section and provide input and discussion of the section.

In putting together a schedule for drafting, reviewing and finalizing the CD&A section, companies should also anticipate the possibility that the Compensation Committee may want to review the draft CD&A section prior to making certain compensation decisions for fiscal 2006. Allowing Compensation Committees to review the manner in which their decisions will be presented to the public may affect their decision-making process, especially in light of those changes to the rules designed to require additional disclosure of practices that many investors view unfavorably.

Regulation By Disclosure

While the new rules do not require any change in the manner by which compensation decisions are made, as a practical matter it seems likely that some companies will alter their behavior in order to avoid the possibility of having to make unfavorable disclosure (with the risks incident thereto). For example, while the new disclosure rules do not require companies to engage in benchmarking in determining compensation, by providing information on benchmarking as an example of an issue that would potentially be appropriate for companies to address in the CD&A section, it seems likely that companies who engage in benchmarking will disclose that fact and companies who do not currently engage in the practice will feel pressure to do so.

In addition, because the new rules lower the threshold for the disclosure of perks to $10,000 and require an explanation of why the company decided to grant those perks, it is likely that some companies will take a critical look at the perks they give to their executive officers and may choose to abandon those perks that are considered less important to executive retention. In that regard, some companies have already taken steps to replace their perk programs with cash compensation, presumably on the theory that the disclosure is less cumbersome and the optics are more favorable.

Similarly, while the revised compensation disclosure rules do not prohibit option granting practices such as backdating or spring-loading, the rules do require disclosure and discussion of these practices in both the required tables and in the CD&A section. Where the date the Compensation Committee takes action is different or deemed to be different from the date of grant (as determined for financial statement reporting purposes pursuant to FAS 123R), an additional column is required to be added that discloses the date of action. The Staff has also made it clear that the setting of an exercise price based on a date other than the actual grant date of options should be discussed in the CD&A section. Given the amount of negative press that has accompanied these types of option granting practices, it seems likely that, instead of trying to draft disclosure explaining the reasons for their use, companies will be increasingly likely to abandon the practices altogether. As with other required disclosures, analyzing the company's option granting policies prior to the end of fiscal 2006 may give Compensation Committees additional time to review and revise those policies prior to making option grants, thereby saving the company from having to make embarrassing or risky disclosure in the 2007 proxy statement.

Being Prepared

Perhaps the most important consideration to keep in mind in drafting executive compensation disclosure is the additional public exposure to certain types of compensation information and compensation decisions that were not previously disclosed. Because their 2007 proxy statements will include compensation information that in many cases was not previously disclosed, many companies will confront a situation in which the public and shareholders will become privy to certain compensation information upon the filing of their 2007 proxy statement.

This will include the narrative discussion and analysis included in the CD&A section, which will require companies to provide a detailed discussion of the methodologies and rationales underlying compensation decisions. In certain instances that may require companies to consider issues that have not been addressed in the recent past — *eg*, why does company policy provide for X (as opposed to Y) times salary as a severance benefit? If those questions have not been asked in the past, they will be this year. With the additional scrutiny that should be expected from the SEC and investors, companies must be prepared to answer difficult questions.

Conclusion

Although it may seem like a great deal of time remains before the 2007 proxy statement must be finalized for companies with calendar year fiscal year ends, companies should keep in mind the changes in the compensation disclosure requirements (including the mechanisms used to solicit input from disparate parties within the organization) and potentially large amount of additional information which will have to be collected when setting the timetable for the drafting of the proxy statement. This additional required disclosure will require many companies to address issues that have not been addressed in the past and to reexamine their compensation practices. Where possible, companies should strongly consider implementing the necessary changes and beginning the drafting process as soon as possible in order to allow for adequate time for review and avoid the possibility of a costly delay.