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# What You Need to Know About New SEC Compensation Disclosure and Analysis Rules

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Long hours could be coming up for corporate HR and legal staffs charged with preparing a proxy statement for next year's annual shareholders' meeting.

The new executive compensation disclosure rules, promulgated this past August by the Securities and Exchange Commission in Release 33-8732, make the most substantial revisions in this area since 1992.

The new rules require enhanced tabular and narrative disclosure of all elements of compensation for the principal executive officer, principal financial officer and at least three of the other most highly compensated executive officers. New information will need to be provided for performance compensation, perquisites, retirement and other post-termination benefits, such as change of control benefits, as well as other types of compensation.

A cornerstone of these rules is the new Compensation Disclosure and Analysis. The CD&A is intended to lead off the proxy statement discussion of executive compensation. It is designed to be a discussion and analysis of the material factors underlying compensation policies for the executive



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officers named in the proxy statement and the compensation data reflected in the tables that follow it. The CD&A should explain:

- the objectives of the compensation program;
- what the compensation program is designed to reward;
- each element of compensation and why the company chose to pay each element;
- how each element is determined, including any applicable formula; and
- how each element fits into overall compensation.

The CD&A should focus on the material principles underlying executive compensation policies and decisions without using boilerplate language. It is intended to put into perspective for investors the compensation numbers that are required to follow it, similar in concept to the MD&A for financial disclosure.

The SEC cautions, however, that it should not merely be a repetition of those numbers. Proxy statements have typically stated that compensation policy was "pay for performance" and that compensation levels were targeted at the middle or some percentile of the peer group.

The CD&A will require disclosure of why certain levels of compensation were selected and how the compensation to be disclosed in the tables implements the company's policies. The SEC intends that the CD&A analyze why the program was set up the way it was, what the company seeks to achieve from the program and whether it is achieving the desired results.

The CD&A is a principles-based disclosure format rather

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than a set of rules requiring specific responses. There will be gray areas in its preparation. The drafter may receive push-back from executives who ask: "Where does it say that I have to disclose that?"

There is also the risk that an SEC review may result in comments that the CD&A does not provide sufficient disclosure as viewed from the SEC's perspective.

Some areas of disclosure may be particularly sensitive, such as perquisites and post-employment arrangements (explaining tax gross-ups or single triggers for change of control arrangements). The SEC is asking for more specificity for the design of performance-based compensation. Companies are not required to disclose the specific performance goals if that information will result in competitive harm, but the SEC has set a high standard for being able to keep those details confidential.

Companies are also required to disclose their policies regarding the timing and pricing of stock option grants. This has received much publicity and, depending on a company's practices, could lead to sensitive disclosure.

Preparation of the CD&A will be a challenging task. It is also a multidisciplinary task. The CD&A should preferably be prepared by a team of internal personnel (counsel, HR and, perhaps, finance) and outside advisers (compensation consultant, securities counsel, compensation counsel and actuary).

A "mock" CD&A should be prepared. This process will demonstrate the complexity of the task and the sensitivity of some of the new areas to be discussed.

The draft should then be reviewed by the compensation committee and senior executives. The compensation committee must file a report in the proxy statement that it has reviewed the CD&A with senior management and has recommended it for inclusion in the proxy statement. In addition, the compensation committee's handiwork for the year will be described in the CD&A. Also, the draft CD&A will show the compensation committee some of the issues to which it needs to be sensitive in the future and policies that it would like to change.

It is only after the drafting is in process that companies will realize the scope of the CD&A and the work that needs to go into it. The process of starting early to complete a draft will alert the drafters to sources of information for the CD&A (such as compensation records maintained overseas for expatriate executives). Senior

executives and compensation committee members will not want to see the draft at the last minute so that revisions may be timely made. The CD&A may be an eye-opener for some compensation committees ("Holy cow – did we approve that?").

Many companies satisfy their obligation to include executive compensation information in their Form 10-K by incorporating that information by reference from the proxy statement. The Form 10-K is often filed before the proxy statement is filed. This complies with the SEC rules as long as the proxy statement is filed within 120 days after the end of the company's fiscal year. The CEO/CFO certification contained in the 10-K as required by Sarbanes-Oxley now covers the new executive compensation disclosures to be incorporated by reference from the future proxy statement. Thus, the CEO/CFO will be providing their certification without necessarily having seen the full version of the proxy statement. They will therefore want to see a pretty final draft of the executive compensation disclosure at the time that the Form 10-K is filed, and the accompanying certification submitted along with it, so that they will know the substance of what they are certifying. The CEO and CFO will be entitled to rely on the compensation committee report in providing their certificates as the CEO/CFO may not be familiar, for example, with what transpired during executive sessions of the compensation committee.

The CD&A is required to be written in "plain English." The compensation programs of some companies are complex and technical. It may be a challenge for the drafter to explain these in plain English.

Companies with smaller internal staffs that find it difficult to allocate staff to this process will be under particular stress. Preparation of the CD&A should commence now. The next proxy season is closer than we think.

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