

## Client Alert.

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# The SEC's New Approach to Your CD&A

By David Lynn and Lawrence Bard

With most public companies focused on the amendments the Securities and Exchange Commission (the "SEC") adopted for its proxy disclosure rules on December 16, 2009,<sup>1</sup> limited attention has been drawn to a key speech made one month earlier by the Deputy Director of the Division Corporation Finance, Shelley Parratt, in which a tough new approach for the Staff's review of executive compensation disclosures was announced.<sup>2</sup>

In the disclosure cycles that have passed since the Compensation Discussion and Analysis ("CD&A") rules became effective in 2006, the Staff generally has addressed disclosure deficiencies identified in the review process through the issuance of "futures" comments, which require an issuer to address any identified deficiencies in future filings. In the new guidance, the Deputy Director stated:

[A]fter three years of futures comments, we expect companies and their advisors to understand our rules and apply them thoroughly. So, any company that waits until it receives Staff comments to comply with the disclosure requirements should be prepared to amend its filings if it does not materially comply with the rules.

The remarks that followed this warning urged companies to focus on three key areas of compensation disclosure, and make reference to the comments, reports and speeches on CD&A provided by the Staff over the years. In particular, Ms. Parratt provided the following recommendations for preparing 2010 proxy statement disclosures:

- Explain *why* compensation decisions were made in the context of addressing the decision-making processes;
- Disclose any material performance targets used in determining executive compensation for the named executive officers for the periods covered by the disclosure, as well as the actual achievement level against the targets;
- In the event of Staff review, be prepared to explain how disclosure of material performance targets would cause competitive harm when that is the basis for omitting the performance target disclosure;
- Provide meaningful disclosure regarding the degree of difficulty in achieving performance targets when those targets are omitted;
- Disclose the names of any peer group companies used for benchmarking purposes, how those companies were selected, and how the actual awards compared to the benchmarks; and
- In addition to addressing the examples provided in Item 402(b) of Regulation S-K, provide additional disclosure in the CD&A that would be material to an understanding of a company's compensation policies or decisions.

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1 For our discussion of the new required disclosures regarding risk, compensation, and corporate governance matters, please see [SEC Adopts New Compensation and Governance Disclosure Rules](#).

2 [Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010, Shelley Parratt, Deputy Director, Division of Corporation Finance \(Nov. 9, 2009\)](#).

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Many of the Staff's concerns can be addressed by focusing on the key areas of the CD&A that are most often the subject of comments raised in the review process. Under the Staff's new approach to resolving comments when material deficiencies are identified in the CD&A, it is increasingly likely that the Staff will seek an amendment to these disclosures if it believes that the Staff's guidance has not been appropriately followed. In view of the fact that comments on disclosures included in the proxy statement are typically raised after the definitive proxy materials are sent, amending the disclosure involves the filing of an amendment to Part III of the Form 10-K, which usually incorporates by reference the information provided in the proxy statement.

## **Analysis in the CD&A**

A key to preparing executive compensation disclosure that will satisfy the Staff and investors is providing the level of analysis in the CD&A that explains the "how" and "why" behind key executive compensation decisions and policies. In the SEC Staff's view, the discussion of the "how" and "why" is often inadequate in the CD&A, with too much focus on describing the decisions made and the mechanics of compensation programs instead of the required analysis.

### *Describing the Analytic Tools*

In order to provide the level of analysis that the Staff expects in the CD&A, it is imperative for the compensation committee to have the appropriate analytic tools in place, and to use those tools when making compensation decisions and setting compensation policies. The tools that the compensation committee may choose to use will depend on the particular circumstances of the company and its executive compensation programs. Compensation committees regularly employ analytic tools such as tally sheets, wealth accumulation analysis, internal pay equity analysis and walk-away numbers in the course of analyzing pay decisions and setting compensation policies. In the Staff's view, as expressed in its comments on executive compensation disclosures, it is never sufficient to reference the use of analytic tools in the CD&A without also providing a complete explanation of how the tools are used in making compensation decisions.

For example, if the CD&A references that the compensation committee has considered walk-away numbers when determining whether to make changes with respect to an executive's post-employment benefits payable upon termination or a change in control, it is important to describe how the analysis of the walk-away numbers factored into the compensation committee's determination and why the compensation committee made the decisions that it made based on the review of the walk-away numbers. Further, in order to put the description of the compensation committee's analysis in context, it may be appropriate to disclose the walk-away numbers and describe how they were calculated.

### *A Focus on Analysis for Each Named Executive Officer*

The Staff generally expects to see in the CD&A an analysis with respect to compensation decisions made for *each* of the named executive officers and for *all* of the elements of compensation considered with respect to those named executive officers. In this regard, the Staff will often raise comments on any general discussion of award decisions that does not relate to each named executive officer's individual circumstances.

In seeking to elicit the "why" behind the elements of compensation paid for each of the named executive officers, the Staff expects a discussion of why the compensation committee determined to award specific amounts or make changes in a specific element of compensation as compared to prior periods. In seeking the additional analysis, the Staff will often ask for a discussion of the specific reasons why the amount of a named executive officer's compensation increased or decreased during the last completed fiscal year. The Staff will often ask the company to explain exactly how the compensation committee actually determined the size of an award made during the fiscal year, necessitating a description of both the "how" and "why" behind the specific compensation decisions.

When a company indicates that compensation decisions are based on individual performance of an executive officer, the Staff will often raise comments asking for more information regarding how that individual's performance has been assessed. In particular, the Staff is looking for disclosure regarding any specific standards against which an executive's

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performance was judged, including any quantitative performance targets that may need to be disclosed as well a description and discussion of qualitative factors.

## *Relationship Between Compensation Decisions and Objectives*

In the Staff's view, it is usually not sufficient for the CD&A to focus on the "how" and "why" behind the individual awards without also explaining how those awards fit into the broader context of the company's overall compensation objectives. The Staff's approach in this area reflects the fact that the CD&A calls for a discussion of both an analysis of what the compensation program is trying to achieve, as well as the more specific details behind individual awards or compensation decisions that have been made with respect to each of the named executive officers.

## **Performance Target Disclosure**

The disclosure of performance targets in the CD&A has caused frustration for the Staff in the three years since the CD&A requirement was adopted. In the Staff's view, the disclosure of performance targets is often necessary as a means of explaining how a company has sought to implement a pay for performance policy underlying its executive compensation programs. However, the CD&A requirement itself provides the means for companies to avoid disclosing specific performance targets, either based on a conclusion as to the materiality of the targets or based on the exclusion available where disclosure of the targets would result in competitive harm to the company.<sup>3</sup>

It is important that companies and compensation committees carefully balance the disclosure considerations around performance targets and make appropriate, justifiable decisions in light of the Staff's new review approach.

## *What Needs to be Disclosed*

Over the past few years, the Staff's comments have indicated that companies must disclose any material performance targets used in determining executive compensation for the named executive officers for the periods covered by the disclosure, as well as the actual achievement level against the targets. The Staff has emphasized that the performance target disclosure relates to the disclosure included in the Summary Compensation Table.

Following the revisions to the executive compensation disclosure rules in 2006, the Staff's comments often sought performance target disclosure with respect to the "forward looking" targets for the current period in which the proxy disclosure was provided, as well as future years in the case of incentive plans with multi-year performance cycles. More recently, it has been communicated through the Staff comment process that once a company has disclosed performance target measures for the last completed fiscal year, the company is less likely to be questioned about performance target measures for the current period in which the disclosure is being made or for future periods, based on the argument that a current period or future period performance target is not material to an understanding of the company's compensation policies and decisions with respect to the last completed fiscal year.

The Staff also expects discussion of the factors considered by the compensation committee when the committee exercises its discretion in determining bonus payments under an incentive plan, particularly when discretion is used to pay more or less upon achievement of a performance target or when a target has not been achieved.

## *Supporting a Competitive Harm Argument*

Whenever an incentive compensation plan is designed so that compensation will be based on achieving specific performance target levels, the principles-based CD&A requirement generally calls for a fulsome discussion of the performance target measures that are used for determining the incentive payouts, whenever that information is material to an understanding of the company's compensation policies and decisions.

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3 See Question 118.04 of the Staff's Regulation S-K Compliance and Disclosure Interpretations.

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The rule provides an exception for the disclosure of any information that would potentially cause competitive harm to the company.<sup>4</sup> The competitive harm standard is supposed to be the same standard that exists under the SEC's rules governing confidential treatment requests, but in application by the Staff through the comment process, it is evident that the Staff applies a very high standard when evaluating whether performance targets must be disclosed.

The Staff typically requests a very detailed explanation of how performance targets could be used by a competitor if ultimately publicly disclosed. The Staff expects and explanation of exactly how a competitor could utilize the insights obtained from a performance target measure to take actions that are competitively harmful to the company. In this regard, the Staff often asks for hypothetical explanations of how the information could be used by a competitor. The Staff remains very skeptical of competitive harm arguments, particularly with respect to any top-line company financial measures. Where competitive harm arguments have been accepted is often in connection with very specific operational targets that might provide insights into specific pricing or business strategies for a company's business units.

## *Acceptable Degree of Difficulty Disclosure*

In those situations where disclosure of performance targets is omitted based on a competitive harm argument, the rule requires meaningful disclosure regarding the degree of difficulty associated with achieving the omitted performance targets. The Staff often focuses on this disclosure when it does permit the targets to be omitted on the basis of competitive harm, often seeking expanded disclosure of historical data regarding whether past performance targets were met, or other indicia of how hard it is to meet the non-disclosed target measures.

## **Benchmarking**

Benchmarking has been an area of frequent Staff comment over the past three years. Benchmarking of compensation as a practice has been criticized, and the Staff's comments have sought to drive a significant amount of disclosure regarding the benchmarking process and the extent to which companies rely on benchmarking data as part of their overall executive compensation policies and practices.

## *Comments on Benchmarking Disclosure*

The Staff's comments focus on ensuring that companies identify and analyze all of the companies comprising the peer group or survey, including a discussion of both the names of the individual companies and, with respect to peer groups, the compensation committee's views as to why the comparator companies were selected to be part of the peer group.<sup>5</sup> In situations where a company has based specific elements of compensation on benchmarks, then Staff comments will focus on eliciting disclosure about where the actual payments and awards made fall within the targeted benchmark range. When the actual compensation for an executive is outside of the benchmark range, the Staff will typically ask the company to explain the reasons behind the compensation paid that was above or below that range.

## *Are you Benchmarking?*

While many companies include disclosure describing some benchmarking practice in connection with the setting of executive pay, it may be necessary to evaluate whether the company is in fact "benchmarking" as contemplated by Item 402(b) of Regulation S-K. Many companies have used the term "benchmarking" in their CD&A, when in fact they are not benchmarking in the way contemplated by the rule. For the purposes of the disclosure in the CD&A, the Staff views benchmarking as using data about comparable companies as a reference point on which to base, justify or provide a framework for compensation decisions.<sup>6</sup> In many cases, companies find that they are using an analysis of comparable

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4 Instruction 4 to Item 402(b) of Regulation S-K.

5 The Staff also expects additional disclosure explaining the rationale behind any changes in the peer group from year to year.

6 Question 118.05 of the Staff's Regulation S-K Compliance and Disclosure Interpretations describes the Staff's view of what is meant by the use of the term "benchmarking" in Item 402(b) of Regulation S-K.

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companies or broad surveys only as a “market check” after determining the amounts of compensation through some other means. Through the comment process, the Staff has been willing to accept arguments that this “market check,” approach does not necessarily mean that all of benchmarking disclosure is then required in the CD&A. Even in those situations where a company is not benchmarking, the CD&A still needs to describe how the company uses any comparative data to evaluate compensation decisions.

### Critical Steps for this Proxy Season

As preparation of your CD&A disclosures swings into full gear, take care to consider your executive compensation disclosure in light of the themes from the Staff’s agenda outlined above. If a company has not received a comment from the Staff on one of these topics in the past, it should nevertheless consider its disclosures with these themes in mind. Even if you have received comments on your CD&A disclosure in the past, you should review those disclosures again in light of the latest trends in Staff comments, particularly given the Staff’s harder line in some areas, such as with respect to disclosure of performance targets. Finally, as a regular part of their disclosure controls and procedures, companies that are not already monitoring comment letters from the Staff to their peers should consider doing so, and keeping those comments in mind throughout their own disclosure process, especially as the comments and responses relate to executive compensation disclosures.

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