

LEGAL UPDATE

November 20, 2008 By: Edward C. Normandin

SEC PROVIDES 2ND YEAR OBSERVATIONS ON EXECUTIVE COMPENSATION DISCLOSURE *Many Public Companies Still Miss the Mark and Risk SEC Comments*

In a recent speech, John W. White, Director of the SEC's Division of Corporation Finance¹, provided his second year observations on the adequacy of executive compensation disclosures by public companies². White's remarks make clear that there are continuing deficiencies in executive compensation disclosures, primarily in the areas of analysis, performance targets and benchmarking. Furthermore, White stated that executive compensation disclosure will remain an important focus for the SEC in 2009 in connection with its traditional review of proxy statements and other filings containing executive compensation and related disclosure. In order to reduce the likelihood of SEC comments on their executive compensation disclosures, public companies, and companies planning to become public, should carefully consider this new guidance.

In 2006, the SEC made extensive revisions to executive compensation disclosure rules affecting public companies, including the requirement of a Compensation Discussion and Analysis (CDA) section in proxy statements. In 2007, the SEC evaluated the disclosures of 350 public companies to determine their compliance with the new disclosure rules and released a report³ discussing its observations on the executive compensation disclosure by such companies in their proxy statements and other reports. The purpose of the SEC's 2007 review was to gauge the level of compliance with the new rules and to provide guidance to the reviewed companies and all other public companies for the 2008 proxy season. At that time, the SEC noted many areas of deficiency, including the manner and clarity of presentation, the detail of the analysis in the CDA and the use of performance targets and benchmarks.

2ND YEAR OBSERVATIONS AND POTENTIAL AREAS OF COMMENT

Unfortunately, many public companies did not carefully follow the SEC's 2007 guidance, as evidenced by the fact that the primary areas of SEC comments in 2008 were substantially the same as those in 2007. The 2008 primary areas of comment were (a) disclosure of performance targets, (b) disclosure related to benchmarking and (c) the need for more analysis. The SEC's second year observations are summarized below.

PERFORMANCE TARGETS. Some important SEC observations and guidance in this area include:

- If performance targets or objectives will be omitted from the disclosure due to competitive concerns, companies must be prepared to justify the omission, if requested, by providing the SEC with a legal analysis of the reasons why competitive harm will result.
- The SEC recommends that an analysis of competitive harm be conducted contemporaneously with the executive compensation disclosure rather than following an SEC inquiry. Any such analysis should be tailored to the facts and circumstances surrounding the company and its industry.
- If a company concludes there is sufficient basis for omitting performance targets, the company must still provide detailed disclosure of the criteria for determining the omitted performance target and the degree of difficulty associated with achieving the target.
- Companies are reminded to follow the principles-based standards for disclosure and to consult the updated SEC Compliance and

Disclosure Interpretations. Boilerplate or rote disclosure will not be accepted.

BENCHMARKING. Some important SEC observations and guidance in this area include:

- Companies that use benchmarks as a material element in setting compensation must disclose the names of the companies constituting the peer group.
- Companies should provide justification for selecting a particular peer group.
- The SEC clarified that the use of broad-based third-party compensation studies or surveys to obtain a general understanding of current compensation practices does not constitute “benchmarking” for the purpose of determining required disclosure.

ANALYSIS. Some important SEC observations and guidance in this area include:

- The CD&A sections of many companies still lacked analytical discussion of the material elements of compensation, how they arrived at compensation levels, and why they believe their compensation practices meet their objectives.
- Those companies that have improved their disclosure in this area have done so by completely overhauling the prior year’s disclosure, i.e., starting with a clean slate.
- Companies should explain and place in context the specific factors considered when approving each named executive officer’s compensation package.
- Companies should provide analysis of why the amounts paid are appropriate in light of the factors they considered in setting compensation levels.
- Companies should describe how and why determinations as to one element of compensation (e.g., cash bonus, restricted stock awards, etc.) affected decisions as to other elements of compensation and whether any relationship exists between them.
- Where individual performance is a significant compensation factor, companies should identify specific contributions and other qualitative

inputs used in making compensation determinations.

- Companies should use minimum, target and maximum levels of performance goals and indicate if and how they were achieved and resulted in specific payouts.
- Companies should provide disclosure on whether their compensation committee reviews each element of compensation or the overall compensation package when establishing the elements and levels of compensation.

OTHER REMARKS

Director White’s remarks during his recent speech included discussion of the implications of the Troubled Asset Relief Program (TARP) on executive compensation and corporate governance policies of the financial institutions participating in the program. Although TARP does not fall within the scope of this Legal Update, it is worth noting that White advised non-participants in TARP to consider the broader implications of TARP by asking compensation committees to consider the risks that an executive might be incentivized to take in order to meet specified performance targets and, if such considerations are a material part of the company’s compensation determinations, they should be disclosed appropriately.

The foregoing is merely a discussion and is not intended to provide legal advice. If you have any questions regarding the SEC’s observations and guidance on executive compensation disclosure, please contact an attorney in Pryor Cashman’s Securities and Corporate Finance Group.

¹ Mr. White recently announced his resignation from the SEC effective at the end of 2008.

² *Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape* speech by John W. White, Director, Division of Corporation Finance, Securities and Exchange Commission, at the 3rd Annual Proxy Disclosure Conference in New Orleans, Louisiana on October 21, 2008, available at <http://www.sec.gov/news/speech/2008/spch102108jww.htm>

³ *Staff Observations in the Review of Executive Compensation Disclosure*, Division of Corporation Finance, Securities and Exchange Commission, available at <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>.

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Edward Normandin devotes his practice to counseling clients on general corporate matters, including mergers and acquisitions, public and private debt and equity financing transactions, joint ventures, securities law compliance, venture capital financing, corporate formation and governance. He has handled complex domestic and international transactions for Pryor Cashman's diverse client base.

Ed has represented clients at every stage of development, with such clients ranging from start-up ventures to publicly traded corporations engaged in a wide range of industries, including pharmaceutical, advertising and media, entertainment, energy, manufacturing software and health services, among many others.

Prior to joining Pryor Cashman in 2000, Ed practiced law with a New Jersey firm where, in addition to his current areas of focus, he represented corporate borrowers and financial institutions in bank lending transactions and counseled clients in technology-related transactions.

Before he became an attorney, Ed served as an active-duty officer in the United States Army and held finance-related positions at several large corporations.

Ed is a 1998 graduate of the State University of New York at Buffalo Law School, where he also earned a Certificate of Concentration in Financing Transactions. Ed has a B.S. in Economics from Siena College and an M.B.A. from Bryant University, where he had a concentration in finance.