

Client Alert

August 5, 2008

SEC Staff Issues Further Interpretive Guidance to Executive Compensation Disclosure Rules

On July 3rd, the SEC Staff issued another of its pre-holiday weekend gifts to those mired in the evolving disclosure process: a set of revised Compliance & Disclosure Interpretations (CD&Is)¹. The new guidance consolidates and adds to the interpretations issued on a piecemeal basis over the years. Within the current update is interesting guidance on a number of issues. This Client Alert highlights the changes this recent update makes to the disclosure of executive compensation.

Standards for Disclosure of Performance Target Levels Clarified: At the outset of its latest guidance, the Staff emphasizes that non-material performance targets are not subject to disclosure. The CD&I further provides that a company may distinguish between *qualitative/subjective* individual performance goals (e.g., effective leadership and communication) and goals that are *quantitative/objective* (e.g., specific revenue or earnings targets). Quantitative targets need not be disclosed for inherently subjective or qualitative assessments, such as how effectively the CEO demonstrated leadership. The Staff also states specifically that the competitive harm standard is the *only permitted* basis for omitting performance targets if they are a material element of the company's executive compensation policies or decisions.

The CD&I also provides additional guidance for competitive harm analyses. It states that a company should (1) consider all facts and circumstances and the nature of the targets; (2) analyze, in the context of its industry and competitive environment, whether a competitor or contractual counterparty could potentially glean information from the disclosure about the company's business or strategy that could be to the company's detriment; (3) provide a reasoned basis for concluding that disclosure of targets would cause competitive harm, based on standards established under specific case law; and (4) not rely on the competitive harm exception if a performance target has been otherwise publicly disclosed.

- **PM&P Observation:** Disclosure of performance targets was the most debated and controversial element of the expanded disclosure rules, as well as the most commented upon in the Staff's letters to companies following the first year under the revised standards. While the extent of required disclosure remains open to interpretation, the Staff seems to be retreating from its original, more Draconian requirement for total disclosure of all metrics and levels of targets that would not cause competitive harm. This CD&I will be especially welcomed by companies that have justifiably been resistant to disclosing soft and subjective individual performance results.

¹ See <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>

Narrowed Definition of Benchmarking: In the context of the CD&A, the new guidance generally defines benchmarking as “using compensation data about other companies as a reference point on which – either wholly or in part – to base, justify or provide a framework for a compensation decision.” The guidance further states this “would not include a situation in which a company reviews or considers a broad-based third-party survey for a more general purpose, such as to obtain a general understanding of current compensation practices.”

- *PM&P Observation:* This CD&I confirms that when data from a specific group of public companies is used in a material way to determine benchmark points, those companies must be disclosed. More importantly, this interpretation states that using a survey that could include data from hundreds of companies would not constitute “benchmarking” for purposes of the CD&A and, presumably, the name of every individual company included in the survey need not be disclosed.

Where should the role of the Compensation Consultant be described? The guidance points out that the role of the consultant, if material in the compensation process, should be discussed in the CD&A and not just in the 407(e) discussion, which focuses on the role of the Compensation Committee and falls outside the CD&A.

- *PM&P Observation:* In the past two proxy seasons, we have observed that the role of the compensation consultant is, almost by necessity, already integrated into the CD&A by most companies.

Reimbursed Perquisites: The guidance clarifies that the entire cost of a perquisite must be reimbursed to render disclosure of the item unnecessary. As an example, the Staff stated that if a company pays for country club annual dues as well as meals and incidentals, and the executive reimburses only for the latter two expenses, the company need not report the meals and incidentals but would continue to report the dues payment.

Determining Named Executive Officers (NEO) after an Expense Reversal: The Staff takes the position that only previously-expensed portions of awards already reported in the Summary Compensation Table (SCT) can be reversed in the table in a subsequent year (thus avoiding the negative number in the stock award column problem). At issue was whether an expense reversal could be considered for an individual who was not in the SCT the previous year to determine if that person should be an NEO in the current year. The Staff concludes that the same rules apply to all executives in determining who is an NEO. Consequently, the reversal of a previously-expensed amount that would have been reported if the individual had been in the SCT the previous year can be considered in determining NEO status. The following is given as an example: During 2007, the same amount of equity compensation that had been expensed in 2006 under FAS 123R was reversed for both A (who was in the SCT) and B (who was not). The amount of this reversal would be taken into account for both A and B in determining whether they are among the company’s NEOs.

Footnote Disclosure: Only some SCT instructions limit footnote disclosure to the past fiscal year (e.g., for detailing perquisites). This led some companies to conclude that footnotes were required for both 2006 and 2007 data, unless the instructions specifically limited footnote

disclosure to the previous fiscal year. The guidance clarifies that if an instruction to the SCT does not limit footnote disclosure to the past fiscal year, footnotes are required for other prior fiscal years only if they are material to understanding the SCT disclosure as a whole.

Disclosure of Grant Date Fair Value Assumptions: When FAS 123R expense is recognized during the most recent fiscal year, the footnotes must reference the financial statements in the year the instrument was granted, rather than the latest fiscal year. Further, the guidance permits the footnotes to the SCT to cross-reference the Grants of Plan-Based Awards Table (GPBAT) footnote assumptions.

- *PM&P Observation:* Cross-referencing multiple filings for awards with different grant dates vesting in one year is a time-consuming exercise, and the resulting disclosure could be long and tedious. Instead, companies should consider simply restating the assumptions for such awards.

Reporting Cash Retention Agreements: A cash retention bonus should only be disclosed in the SCT in the year the service-based condition is satisfied. It should not be reported as a bonus that has been earned but deferred, nor should it be reported in the Non-Qualified Deferred Compensation (NQDC) Table. However, it should be discussed in the CD&A in the year in which it is granted, as well as every subsequent year until the condition is satisfied.

- *PM&P Observation:* Contrast this treatment with disclosure of an equity-based retention bonus (rendering it an “equity award” as that term is used in the disclosure rules). The accounting charge for both the cash-based and equity award would be reflected in the financial statements over the service period. However, while the equity award would be reflected in the SCT over the service period, the cash-based award would not hit the SCT until the end of the service period. Therefore, if disclosure and/or determination of NEO status are at issue, careful consideration should be given to structuring awards intended to encourage retention.

Vesting Dates May be Reported in a Column: In the Outstanding Equity Awards Table, companies may add a column for vesting dates, rather than providing such dates as footnotes. The table must also include any different vesting schedule applicable to any of the awards.

Clarification on NQDC Table: The guidance clarifies that information must be provided on a plan-by-plan basis. Additionally, contributions to an NQDC that are earned during one year, but are not payable until January of the following year, are nonetheless reported in the All Other Column of the SCT in the year earned.

Subsidiary/Parent Issues – Allocating Values: If both a subsidiary and parent are reporting companies, any compensation paid to the subsidiary NEO by the parent is generally reported in the subsidiary’s SCT. If, however, a portion of the subsidiary NEO’s payment from the parent is for services to the parent, the subsidiary’s SCT can exclude payment to the subsidiary NEO for services rendered to the parent company.

Subsidiary/Parent Issues – Determination of NEOs: If an NEO receives compensation for services rendered to both a public parent and its public subsidiary, the parent company must include both amounts in determining whether or not the individual is an NEO of the parent. The guidance adds that a parent company’s NEO determination should not be affected by whether its subsidiary is public or private.



The CD&Is have proven a valuable means of communicating the SEC’s position on controversial and complicated rules and situations. In this latest round, further clarification regarding the disclosure of targets and benchmarking practices is likely to provide welcome relief for many companies as they anticipate the third round of disclosure under the expanded rules. We expect that the SEC will continue to provide updated interpretive guidance from time to time in response to questions and comments posed by practitioners. Given the SEC Staff’s proclivity for holiday gifts, we look forward to what they may have in store for us over Labor Day.



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