

# Client Alert

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## **The SEC's Second Phase of Proxy Review: Summary of Staff Findings and Observations**

The SEC's Corporate Finance Division Staff completed the second phase of its executive compensation disclosure review with the October 9 publication of its general observations of 2007 proxies. That same day, Division Director John White gave a speech reinforcing the principles contained in the report, focusing on the analysis and presentation of information in the filings.<sup>1</sup>

Our August 24, 2007 Client Alert<sup>2</sup> described the first phase of the SEC's targeted review of approximately 350 companies, which requested very specific information or enhancement of those companies' proxy statement disclosures. The SEC is expected to post those comment letters and related company responses on its EDGAR system at least 45 days after it completes its review, but probably not before early November.

<sup>1</sup> The report and speech are posted on the SEC's website at <http://www.sec.gov/divisions/corpfm/guidance/execcompdisclosure.htm>, and <http://www.sec.gov/news/speech/2007/spch100907jww.htm>, respectively

<sup>2</sup> See <http://www.pearlmeier.com/knowledgecenter/articles/pdf/ClientAlert082307.pdf>

In preparing for the 2008 proxy season, all companies should be mindful of the general guidance issued in the report, as well as the Staff's individual comments to targeted companies. Highlights include:

- 1. Materiality and Analysis.** Both the SEC Staff and White commented that the CD&As failed to focus on how and why compensation decisions and policies were made, instead over-emphasizing program mechanics and decision-making procedures. White also noted that the 15 supplemental items designated as examples in the rules need not be discussed if they are not materially relevant.

***Observation:** Other than simply stating that the CD&As should focus on materiality and that many of the disclosures contained too much immaterial information, the SEC Staff left companies to determine exactly what rises to the level of materiality. This task must be revisited for the 2008 proxy season but will likely result in companies erring on the side of conservatism and continuing to include information that is only peripherally material.*

- 2. Formatting.** While the Staff generally found a consistent format used by the companies reviewed, it cited a number of instances where the manner of presentation adversely affected the clarity of the disclosure. Specifically:

- The tables should not precede the CD&A
- Non-required charts should only be included if they are helpful and don't obfuscate information contained in the required tables or narratives

> For example, the Staff found the non-required termination and change-in-control tables to be beneficial, but went a step further and asked that any such additional tables include a "total" column for each termination event.

> Conversely, several companies provided alternative summary compensation tables (SCT) that calculated values in a manner inconsistent with the rules, but which they believed more accurately explained their compensation program. The Staff said such alternative tables should not de-emphasize the required SCT and should be appropriately labeled as "Alternative" tables. In some instances, companies were asked to explain in the proxy how the alternative SCT differed from the required SCT.

**3. Clarity.** The Staff continues to assert that Plain English should result in more precise and effective discussions. It offered several drafting tips:

- Replace boilerplate discussions of individual performance with more specific analysis of how the committee considered and used individual performance to determine compensation
- Do not duplicate information from required table narratives in the CD&A
- Avoid using technical language from plan documents in the CD&A
- Consider creating an executive summary

**4. Impact of Philosophy/Decision-Making Processes.** While many companies went to great lengths to describe their compensation philosophies, they often failed to link the philosophy to the numerical table data. In addition, even when the decision-making process was described in detail, the how and why was often missing.

**5. Differences among NEO Pay.** The CD&A must explain any material differences in compensation pay levels or programs between named executive officers (NEOs). If they are the same for multiple NEOs, the descriptions can be grouped together.

***Observation:** Under the prior disclosure rules, a separate description of the CEO's pay was required. Now, it is only needed if it differs materially from that of the other executives.*

**6. Performance Targets.** The lack of disclosure with respect to performance targets was the most frequent comment made in the SEC's first phase of review. The Staff reiterated the following concepts:

- If a target is immaterial to executive compensation policies, it need not be disclosed
- If a target is material, the company may still withhold targets if it determines that disclosure would result in competitive harm
- If disclosure is withheld on the competitive harm basis, (i) the disclosure must adequately discuss the difficulty of achieving these targets, and (ii) the company must be prepared to provide sufficient explanation as to why competitive harm would result

***Observation:** In individual comment letters, the Staff stated that the use of boilerplate language such as "targets are stretch goals" is insufficient. While a satisfactory response may be difficult to draft, one approach would be to describe historical levels of achievement or attainment of target.*

- In addition to targets for the last fiscal year, disclosure of prior or current year targets should likewise be disclosed if material to an understanding of the executive's compensation for the last fiscal year. For example, such disclosure should be considered in the context of a multi-year compensation plan, or when target levels vary materially between years
- If a non-GAAP measure financial figure is used, the company must disclose how it would calculate that figure

***Observation:** Many comment letters requested more detail and explanation in cases where compensation decisions were based on achievement of qualitative individual measures. Many practitioners believe these comments reflect the Staff's push for more objective and formulaic plans. However, both the Staff's review and White's speech reaffirm that the SEC does not frown on subjective assessments, but simply wants companies to better explain how qualitative inputs are linked to objective pay determinations.*

- 7. Benchmarking.** If benchmarking is material to compensation policies and decisions, both the benchmark and its components must be identified, including a list of companies used in the comparison. Additionally, the nature and extent of any discretion exercised in applying benchmarking results must be disclosed.

***Observation:** Several comment letters asked companies that benchmarked against survey data to name all the companies in the survey. However, in the case of larger and general industry surveys that might include hundreds of participants, we believe the company-by-company participant list would not rise to the level of materiality that would subject it to disclosure.*

- 8. Termination and Change-in-Control.** While disclosure in this area was largely quantitative, the Staff requested further analysis of the following areas:

- The rationale for entering into contractual arrangements
- How and why the amount and formula for the severance or change-in-control payment was determined
- How the payment impacted other elements of compensation and fit into the overall compensation program

- 9. Compensation Tables.** The Staff made very few comments regarding the tables. However, quite a few companies apparently failed to provide the following required information:

- All assumptions (or cross-references) regarding valuation of equity awards
- All grants of awards made to executives in the Grants of Plan-Based Awards table
- Footnotes to the Outstanding Equity Awards table in regard to vesting dates of options, shares and equity incentive plan awards

**10. Corporate Governance.** Any role played by an NEO in executive compensation decisions must be disclosed and explained. Similarly, in regard to any services provided by a compensation consultant, the specific nature and scope of the assignment and material instructions given by the company must be disclosed.

We understand that this is the last piece of general guidance that will be offered by the SEC prior to the second proxy season under the new disclosure rules. While these comments provide additional guidance regarding analysis and formatting, the emphasis is clearly on providing shareholders with additional insights into the “why” of compensation outcomes. The challenge for companies in preparing their 2008 proxies will be to satisfy shareholders’ appetite for more detailed information about pay, but in a form that respects the dual requirements of clarity and relevance.

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