

# INSIGHTS

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## EXECUTIVE COMPENSATION

### The New Compensation Discussion and Analysis

*The SEC has introduced in its new executive compensation disclosure rules a totally new requirement—the Compensation Discussion and Analysis or CD&A. Modeled on the Management Discussion and Analysis of Financial Conditions and Results of Operation (MD&A), it will require a comprehensive analysis of the principles surrounding and the amounts paid under companies executive compensation programs.*

by **Robert M. Hayward and Theodore A. Peto**

Perhaps the most significant impact of the SEC's new executive compensation rules is to require a comprehensive, principles-based narrative discussion and analysis of compensation entitled "Compensation Discussion & Analysis" or "CD&A" (think of this as an MD&A on compensation). Preparing the CD&A will, for most companies, be the most challenging and time-consuming aspect of implementing the new rules since the required disclosures are unlike any that companies have previously been required to make. The following is a summary of recommended practices in implementing the SEC's new CD&A disclosure requirements.

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### Gathering the Facts

The CD&A will, for most companies, require development of new narrative disclosure regarding material principles underlying compensation policies and decisions. There are numerous ways in which the disclosure team may gather the relevant information to prepare the CD&A. The following is merely one path, among several, in preparing for the new CD&A disclosure requirements.

### Reviewing Background Materials

Ideally companies would have known that the SEC's new disclosure requirements were forthcoming several years ago. With this knowledge companies could have set in place a system of disclosure controls and procedures such that a member of its disclosure team was present at the relevant meetings of the compensation committee and board of directors when compensation policies were crafted and compensation decisions made. The member of the disclosure team would see that the minutes of these meetings reflected details of the various factors considered by the compensation committee and/or the board of directors in setting compensation policies and making compensation decisions.

This is not a perfect world, however, and several companies will need to do some research on themselves in preparing the CD&A. While there are several ways to begin this research, we suggest beginning with reviewing any

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documentation that contains insight into the analysis and rationale underlying the company's compensation policies and decisions. These documents may include: board and compensation committee minutes, human resources policies and procedures, compensation consultant reports and presentations, surveys, benchmarking data, wealth accumulation analyses, compensation committee reports and tally sheets.

The value of this review will to a large extent depend on the level of analytic detail contained in the materials. The most useful documents will help explain not only what the company's compensation policies and decisions have been but the reasons *why* the company choose to implement such policies and to make such decisions. At a minimum however, the review should increase the efficiency and effectiveness of the real time meetings discussed subsequently.

### **Meeting with the Board, Compensation Committee, Management and Consultants**

In its adopting release concerning the new rules, the SEC has focused on the analysis component of CD&A. It will not be enough to merely explain what the company's compensation policies and decisions have been. Rather disclosure will be required concerning the reasons *why* the company chose to implement such policies and to make such decisions—the CD&A should be a roadmap to the company's detailed tabular compensation disclosures. Because of the emphasis on analysis, reviewing background materials will in most cases simply not provide enough information to properly prepare the CD&A. Rather, in most cases, meetings or drafting sessions with the persons responsible for implementing the company's compensation policies and making compensation decisions will be required.

The questions that are required by the CD&A, and therefore should be discussed, include:

- The objectives of the company's compensation programs;
- What the company's compensation programs are designed to reward;
- Each element of compensation and why the company chooses to pay each element of compensation;
- How the company determines the amount (and,

where applicable, the formula) for each element of compensation; and

- How each compensation element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements.

In addition, the new rules contain a list of example issues that may, depending on their materiality, be appropriate to be discussed in the company's CD&A. These examples include:

- What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- How determinations are made as to when awards (including options) are granted;
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (*i.e.*, how gains from prior option or stock awards are considered in setting retirement benefits); and
- The impact of accounting and tax treatments of a particular award.

These are just examples, however, and therefore are neither exhaustive nor necessarily relevant to each applicable company.

### **Preparing a Draft Compensation Discussion and Analysis**

Preparing the CD&A will, for most companies, be the most challenging and time-consuming aspect of implementing the new rules since the required disclosures are unlike any that companies have previously been required to make. The CD&A's breadth is illustrated by the six required disclosure topics and, although non-exhaustive, the 15 examples included in Item 402(b) of Regulation S-K. In addition, Instruction 2 to Item 402(b) of Regulation S-K states that "[t]he Compensation Discussion and Analysis should be of the information contained in the tables and otherwise disclosed pursuant to this Item." The first year of implementing the CD&A will be particularly challenging in that companies will not know the composition of their named executive officers or the contents of its tabular disclosures until after year end. It probably goes without saying, however, that companies should begin preparation of their draft

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CD&A and tabular disclosures now and make revisions as compensation data becomes available.

The CD&A must be written in a clear, concise and easily understandable manner in accordance with the SEC's "plain English" requirements. While there are several different approaches to preparing the first draft of the CD&A, ideally the first draft will be prepared by someone at the company who has a detailed knowledge of the material principles underlying the company's compensation policies and decisions. Irrespective of who prepares the first draft, the disclosure team should be prepared for several revisions and rounds of comments on the CD&A. The following is a list of certain of the more significant points to consider in preparing the first draft of the CD&A.

### **Principles Based Disclosure**

If one point is made clear by the SEC in its adopting release it is that the new rules are principles based. This theme is perhaps most apparent in the CD&A where companies and their counsel will be faced with difficult disclosure decisions concerning materiality. In his September 6, 2006 speech entitled "Principles Matter," the new Director of the Division of Corporation Finance mentions the term "principles" nearly 50 times. The new rules provide six topics, discussed previously, which are required to be disclosed and fifteen examples which, depending on their materiality, may or may not be required to be disclosed. As a starting point in drafting the CD&A the focus should be on the material principles underlying the company's compensation policies and decisions. It is imperative however that the CD&A be reviewed and revised as tabular disclosures regarding compensation subsequently become available.

### **The Time Period to Cover**

As already discussed, the CD&A is a broad, principles based disclosure requirement necessitating disclosure of material principles underlying compensation policies and decisions. Given this context it is no surprise that the SEC did not draw bright line tests regarding the time period to be addressed in the CD&A. Rather, Instruction 2 to Item 402(b) of Regulation S-K states:

The Compensation Discussion and Analysis should be of the information contained in the

tables and otherwise disclosed pursuant to this Item. The Compensation Discussion and Analysis should also cover actions regarding executive compensation that were taken after the registrant's last fiscal year's end. Actions that should be addressed might include, as examples only, the adoption or implementation of new or modified programs and policies or specific decisions that were made or steps that were taken that could affect a fair understanding of the named executive officer's compensation for the last fiscal year. Moreover, in some situations it may be necessary to discuss prior years in order to give context to the disclosure provided.

Companies should anticipate the reaction of investors and the public and do what is necessary in advance of the proxy season to fix any potentially damaging disclosure. One benefit of this fairly broad time period is that companies will be able to discuss corrective actions that they have taken after fiscal year end—a helpful tool if previous compensation policies and practices are likely to be criticized or would lead to unintended results.

### **Aggregating or Disaggregating Named Executive Officers**

The new rules indicate that the CD&A should identify material differences in the company's compensation policies for each individual named executive officer. When compensation policies and decisions are materially similar, named executive officers may be grouped together. If, however, compensation policies or decisions are materially different for a particular named executive officer (such as the principal executive officer), his or her compensation policy and decision should be described separately.

### **Avoid Boilerplate Disclosure**

Under the new rules, the CD&A will be "filed" and not "furnished" and therefore subject to the general liability standards under the Securities Act of 1933 and the Securities Exchange Act of 1934. In the adopting release, the SEC indicated that its previous belief that a "furnished" compensation committee report would lead to more robust disclosure was unjustified given what the SEC considered to be a prevalence of boilerplate.

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## A Few CD&A Pointers\*

Directors on the compensation committee are now responsible for, and have to “sign off” on, the disclosures in the CD&A (through the new compensation committee report). Here are a few pointers that underscore some of the “Hot Button” items that directors will now want to anticipate and focus on as they consider- and review drafts of- their company’s proposed CD&A.

### **Policies: It Will No Longer Be Sufficient to Just Set Forth “Policies”**

The *analysis* that is now required in the CD&A means that when a company, for example, sets forth in its tax discussion its policy about Section 162(m) \$1 million cap compliance or providing tax gross-ups to executives, the company will then have to set forth in the CD&A:

- Actual material outcomes with respect to the CEO and the NEOs (*i.e.*, who will receive what amounts, and the additional costs incurred by the company from the lost tax deductions)
- Analysis explaining how these amounts were factored into, and affected, the compensation committee’s “decisions” (*i.e.*, whether these additional amounts were considered and factored into the calculation of the executive’s total compensation at the time it was approved by the compensation committee, and the justification for the additional compensation and costs)

### **Benchmarking**

Similar critical analysis will apply to benchmarking. Companies will now have to disclose not only whether they “target” a certain percentile, but then will also need to address whether the total compensation paid actually differed from the stated policy. If surveys or data are referenced, the disclosure will have to take much more care in analyzing the data to ensure real apples to apples comparisons, not just with peer groups, but with the total compensation delivered to, and accumulated by, a given executive. To counter over-reliance on external survey data and demonstrate balanced analysis, many analyses may also now need to address whether the company undertook its own internal pay studies and how it factored-in the findings.

### **The Elements**

Each of the elements of the CEO’s (and NEOs’) compensation will need to be analyzed in relation to the *whole*. The following are some “hot button” examples.

*Perks.* If a company provides perks that have significant value to the executive (*e.g.*, airplane perks, etc.), it will not be sufficient to set forth “to be competitive” justifications.

*Retirement, Severance & CIC Provisions.* Analysis will now be the order of the day. This means the CD&A will now need to address uncomfortable questions such as: (1) Is there any longer a need for a severance provision after an executive (hired, say, three years ago) has now become established in his position? or (2) Is there any longer a “need” to provide for post-employment financial security once a CEO has already accumulated a significant nest egg from previous equity and long-term incentive grants?

*Stock Options and Restricted Stock Grants.* Here, too, analysis will need to address how “gains from prior option or stock awards were considered” and affected the decisions. [This is where a company can set forth, in its analysis that it has implemented a hold-until-retirement requirement and where the analysis should squarely address the size of the accumulated “carried interest” and whether additional grants will add any incremental motivational value.]

### **Analytical Tools**

Part of the analytical process will now require addressing the tools that the compensation committee utilized. It should be recognized that the SEC’s new “plain English” guidance underscores the need for headings and subheadings. For example, tools that the committee uses—such as tally sheets, wealth accumulation analyses, and internal pay equity studies—will need to be fully described (including the findings and resulting actions). It will not be sufficient to say that they were employed (or to provide comparative charts) and then to conclude that the amounts in question were found “reasonable” or “appropriate,” unless the findings from those studies are set forth and analyzed/addressed.

\* This book appeared in the September/October issue of *The Corporate Counsel*. Reprinted with permission.

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erplate compensation committee report disclosure. In drafting the CD&A, companies should be prepared to go well beyond what was required in previous compensation committee reports and craft disclosure which is principles based and unique to its particular facts and circumstances. The CD&A should be the roadmap to the company's tabular compensation disclosures, much like the MD&A is the roadmap to the company's financial statements.

### **Confidential Trade Secrets or Confidential Commercial or Financial Information**

Despite their expansiveness the new rules do make clear, consistent with current practice, that award targets that contain confidential commercial or business information are not required to be disclosed in the CD&A. Companies need not formally seek confidential treatment of omitted information but omitted information must satisfy the SEC's confidential treatment standards embodied in Securities Act Rule 406 and Exchange Act Rule 24b-2. Moreover, if information is omitted, the company must disclose how difficult it will be for the executive and/or how likely it will be for the company to achieve the undisclosed target—a delicate task that may lead companies to reevaluate targets used in compensation packages. In addition, the company should document its confidential treatment analysis; Securities Act Rule 406 and Exchange Act Rule 24b-2, in advance as the CD&A will likely be an area of SEC review and comment.

### **Option Grants**

As anticipated, an area of focus in the new rules is option grants and practices. The new rules require that if a company had since the beginning of the last fiscal year, or intends to have during its current fiscal year, a program, plan or practice to coordinate the timing of option grants to executives (including new hires) with the release of material non-public information (such as granting options prior to the release of such information, delaying the release of such information until options are granted, delaying grants until after the release of such information, or releasing such information prior to the option grant), such program, plan or practice must be disclosed. If the company has such a program, plan or practice, the company should also disclose that the compa-

ny's board of directors or compensation committee may grant options in coordination with the release of material non-public information and consider disclosure about how that is taken into account when determining whether and in what amounts to make such grants.

Further, the adopting release indicates that companies should pay particular attention to, among other things, the following when drafting the CD&A:

- How does such program, plan or practice to grant options to executives fit into option grant programs, plans or practices for employees more generally?
- What was the role of the compensation committee (including whether or not it delegated its authority) and executive officers in administering such program, plan or practice?

In addition, companies will be required to disclose whether they have a program, plan or practice of setting the exercise price of option awards based on the stock's closing price other than the grant date including the use of formulas, if any, based on the company's trading price, before, during, or after the grant.

### **Why You Should Care**

The CD&A will require disclosure of material principles underlying compensation policies and decisions. This information, highly sensitive to executives and highly sought by investors and the public, has far-reaching potential. The company has the opportunity in its disclosures to explain the rationale and analysis behind its compensation policies and decisions. The company should be cognizant however that, by its nature, the CD&A will likely be scrutinized by its investors and the public. Furthermore, under the new rules the CD&A will be "filed" and not "furnished" and therefore subject to the general liability standards under the Securities Act and the Exchange Act. Given the importance of the CD&A to the SEC's overhaul of executive and director compensation disclosure rules, companies should be prepared for SEC review and scrutiny. As if this wasn't enough, compensation committees, CEOs and CFOs have additional incentives to become personally involved in preparation and review of the CD&A.

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## **Compensation Committees—The Revised Compensation Committee Report**

With the addition of the CD&A, the SEC has decided to scale back the compensation committee report, concluding that it has not served the intended purpose of providing meaningful disclosure about compensation matters. While the size of the compensation committee report will decrease, its coverage will arguably increase exponentially in that members of the compensation committee will be required to sign a statement that they have reviewed and discussed the CD&A with management and recommended inclusion of the CD&A in the company's public filings.

## **CEOs and CFOs—Sarbanes-Oxley Certifications**

Under the new rules, the CD&A will be covered by the CEO and CFO certifications under the Sarbanes-Oxley Act. The certifications will be required despite the fact that in most cases the CEO and CFO will not

participate in either the board of directors' and compensation committees' development of compensation policies nor the implementation of certain compensation decisions. In response to comments raised on this topic, the adopting release notes that the CEO and CFO will be able to "look to the compensation committee report in providing their certifications"—in essence a "sub-certification" of the CD&A disclosures from the compensation committee.

## **Conclusion**

With the SEC, investors and the public focused on executive and director compensation, it is in the best interests of all parties involved in the disclosure process to work together and spend the time and resources necessary to properly prepare the CD&A. The CD&A will undoubtedly present both unprecedented challenges and unique opportunities as companies provide insight into the material principles underlying their compensation policies and decisions.

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