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TROUTMAN SANDERS
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e-Alert
Securities & Capital Markets

WHY THIS ALERT:
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Disclosure Controls and CD&As

"In light of the fact that numerous deficiencies existed, disclose in reasonable detail the basis of your officers' conclusions that the company's disclosure controls and procedures were nonetheless effective as of the end of the period covered by the report."

SEC Comment

Since 2003, public companies have been required to have a system of disclosure controls. In fact, CEOs and CFOs are required to certify to the effectiveness of this system in their Form 10-Qs and Form 10-Ks, and the failure to have in place an effective system can lead to comments from the SEC similar to the one quoted above -- usually triggered by an MD&A or other disclosure problem -- as well as to more significant penalties.

Companies should revisit what disclosure controls are, and what disclosure controls they now need to implement to ensure an accurate and effective CD&A. Rule 13a-15(e) defines disclosure controls as:

[C]ontrols and other procedures of an issuer that are designed to ensure that information required to be disclosed . . . is recorded, processed, summarized and reported, within the time periods specified . . . . Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits . . . is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely

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decisions regarding required disclosure.

Companies have addressed this requirement in a variety of ways, including detailed checklists, disclosure committees and sub-certifications. Fundamentally, however, good disclosure controls encompass far more than any of these items individually suggests: They are the systematic processes followed by a company to ensure the completeness, accuracy and timeliness of SEC filings.

Given the novelty of the CD&A requirement, few companies have updated their disclosure controls to reflect the additional disclosure that the SEC now requires. Since no two companies will have identical compensation setting practices, likewise no two companies will have identical disclosure controls relating to compensation disclosure. However, there are likely to be common elements, including:

- *Identification of the individuals who need to be discussed. (In order to be prepared for future years, you should include individuals who possibly could be executive officers in the future in order to contemporaneously capture the appropriate information)*
- *Review compensation committee agenda, board materials and minutes. (Consider possible revisions to minute-keeping practices in order to better reflect not just outcomes but also related discussions.)*
- *Discuss with head of HR and, where necessary, CEO compensation decisions with respect to each individual.*
- *Interview chairperson of compensation committee.*
- *Review employment agreements and benefit plans to confirm that they are properly being applied and described.*
- *Review "personnel actions" (or other internal documentation of position or compensation changes).*
- *Interview compensation consultant.*
- *Review W-2s, 1099s, actuarial studies and other supporting materials.*
- *Perform accounts payable search to ascertain what payments were made to executive officers other than through payroll system.*
- *Review travel and entertainment expenses to confirm business nature of expenses.*
- *Review other G/L accounts that are likely to reflect payments for perquisites and related party transactions.*
- *Require questionnaire to be completed each time compensation is modified.*

Each of these items will play a different role within each company. Some reflect the entirety of the task. Others reflect just the tip of the iceberg. Depending upon the company, we

would expect disclosure controls relating to CD&As to be outlined in a two to three page document. Some controls may lead to future changes in compensation setting practices. For instance, we believe that companies will place greater importance on simplifying their compensation setting process, possibly through eliminating insignificant differences in practices among officers.

Documentation of the facts underlying the disclosure is important for at least two reasons. First, it is important to having effective disclosure controls. Second, at least for middle market and smaller companies, since CD&As will be incorporated by reference into Securities Act registration statements, we expect underwriters to include some CD&A information in their "circle-ups" for comfort letters. There will need to be at least a "schedule prepared by management" to provide the required support.

In addition, the development of good disclosure controls is an iterative process. It consists of:

- *systematically cataloging the types of compensation related information that your company has or can generate;*
- *identifying the most reliable sources for the information;*
- *documenting the process, although we do not believe to the same level of detail that is required by PCAOB No. 2; and*
- *starting over, and improving the process even more*

As a result, it may take companies several years to implement the best possible disclosure controls.

The new SEC CD&A rules are effective, however, and the CEO and CFO certifications in upcoming 2006 Form 10-Ks will cover them even though for most companies the first CD&A will not be filed until the definitive proxy statement is filed subsequent to the filing of the Form 10-K. As a result, for this year, companies need to implement at least basic disclosure controls for CD&As by the time their Form 10-Ks are filed. In future years they can refine their disclosure controls to reflect the best possible practices.

See our e-alert dated November 2006 that describes the six types of disclosure required in CD&As and the examples of fifteen issues that the SEC believes might be appropriate for disclosure.

This memorandum provides only a general overview of

the new SEC rule on executive compensation rules, and is not designed to provide legal advice or a complete analysis of the new rules. Questions concerning this memorandum may be directed to your contact at Troutman Sanders LLP or any member of its Securities and Capital Markets Group.

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