Another Challenge for Directors:

The SEC's New Compensation Discussion and Analysis

The SEC recently adopted new executive compensation rules in response to the heightened attention focused upon executive compensation. Unlike the Sarbanes-Oxley Act, which required companies to institute new policies and procedures for corporate governance over a period of time, the new SEC compensation disclosure rules focus upon disclosure of existing compensation practices. By requiring additional disclosure, the new rules effectively require boards to go through expanded compensation setting processes. Also, although not a stated goal of the new rules, some companies may opt to revise their compensation arrangements in order to avoid negative publicity from the media and institutional and other shareholder groups. In addition, the plaintiffs' bar may use the rules to justify the application of a higher duty of care standard in determining whether directors are protected by the business judgment rule when making compensation decisions.

These new rules are effective November 7, 2006, and are applicable to registration statements and proxy and information statements filed on or after December 15, 2006 that are required to include compensation disclosures for fiscal years ending on or after December 15, 2006. Calendar year companies must comply with the new rules for the 2007 proxy season.[1] Certain of the disclosures do not apply to small business issuers, and certain other aspects require less disclosure for small business issuers.

New Compensation Disclosure Tables

The new rules require proxy and information statements (and Form 10-Ks) to include additional tabular disclosure and expanded explanations of historical compensation and the cost of that compensation to companies for "named executive officers,"[2] as well as expanded information concerning director compensation. While this additional disclosure may initially be taxing on companies' accounting, legal and human resources staffs, the information required is mostly objective in nature. The new rules do not require companies to "restate" compensation disclosures for prior fiscal years and, in fact, companies will not be required to present prior years' compensation disclosures for fiscal years ending prior to December 15, 2006, in proxy and information statements (and Form 10-Ks, which may be incorporated by reference from a filed definitive proxy or information statement) containing the expanded compensation disclosures required by the new rules. Companies that begin gathering the information early should have relatively few issues in complying with this aspect of the new rules. In fact, this information is needed for the preparation of the new Compensation Disclosure and Analysis section.

New Compensation Disclosure and Analysis ("CD&A")

The new rules require (except for small business issuers) substantial additional discussion regarding the company's compensation policies and decisions regarding the named executive officers through a new "Compensation Disclosure and Analysis" section. The CD&A is patterned on the philosophy of Management's Discussion and Analysis of financial information and is principles-based. We believe that most companies will find the new CD&A extremely challenging.

The CD&A must include an explanation of "all material elements" of the compensation of its named executive officers - basically the reasons why the top executives are paid their level of salaries and other compensation. While CD&A must cover compensation for the last fiscal year, the CD&A may also require discussion of post-termination compensation arrangements, on-going compensation arrangements and policies that the company will apply on a forward basis.

The new rules specifically require the discussion of the following six items in the CD&A:

(1) The objectives of the company's compensation programs;

(2) What the compensation program is designed to reward;

(3) Each element of compensation;

(4) Why the company chooses to pay each element;

(5) How the company determines the amount (and, where applicable, the formula) for each element of compensation; and

(6) 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.

The new rules also provide illustrative <u>examples</u> of fifteen issues that would be potentially appropriate to address. The list is non-exclusive and must be tailored to the company. These fifteen issues, which we believe will evolve into near-required disclosures, include:

(1) Policies for allocating between long-term and currently paid out compensation;

(2) Policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;

(3) For long-term compensation, the basis for allocating compensation to each different form of award;

(4) How the determination is made as to when awards are granted;

(5) What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;

(6) How specific forms of compensation are structured and implemented to reflect the

company's performance;

(7) How specific forms of compensation are structured and implemented to reflect individual performance and/or contribution to the company's performance;

(8) Policies and decisions regarding the adjustment or recovery of awards or payments if the relevant company performance measures are restated or otherwise adjusted;

(9) Factors considered in decisions to increase or decrease compensation materially;

(10) How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation;

(11) The basis for selecting particular events as triggering payment following, or in connection with, any termination or change-in-control;

(12) Accounting and tax treatments of forms of compensation;

(13) Equity or other security ownership requirements or guidelines and policies regarding hedging the economic risk of such ownership;

(14) Any benchmarking of total compensation or any material element of compensation; and

(15) The role of executive officers in determining executive compensation.

Drafters of the CD&A must bear in mind that (i) there are no bright-line rules regarding the issues that the company must disclose, (ii) no disclosure of an issue is required if the issue is not material to the company and (iii) boilerplate is not acceptable. Given the breadth of these new disclosure obligations, it is important for directors and their advisors to start now in becoming familiar with these new rules.

We have developed a sample CD&A that we would be happy to provide to you. If you would like a copy, please contact any of the members of our Securities and Capital Markets Group.

New Compensation Committee Report

The CD&A is included in lieu of the former compensation committee report and under authority of the board of directors rather than the compensation committee. However, the new rules require the compensation committee to include under the name of the committee members in the company's Form 10-K a Compensation Committee Report in which the committee states whether it has:

- Reviewed and discussed the CD&A with management; and

- Based upon this review and discussions, recommended to the full board of directors that the CD&A be included in the company's proxy or information statement or Form 10-K.

Thus, after the CD&A report is finalized, the compensation committee must meet and discuss the CD&A with management, following which the full Board must consider the recommendation of the committee as to whether to include the CD&A in the company's proxy or information statement (or Form 10-K).

Compensation Committee Governance

Separate and apart from the CD&A (which focuses on compensation policies and objectives and putting quantitative compensation disclosure into perspective), the SEC has adopted new disclosure requirements concerning the governance structure of the compensation committee (or persons performing the equivalent functions).

This new provision requires, in a proxy or information statement, a description of the compensation committee's processes and procedures for the consideration and determination of executive and director compensation, including:

- The scope of authority of the compensation committee;
- The extent to which the compensation committee may delegate any authority to other persons;
- Any role of executive officers in determining or recommending the amount or form of executive and director compensation; and
- Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation.

In addition, the company will be required, as it is with its audit committee charter, to disclose the address of the company's web site on which its compensation committee charter appears or, if it does not appear on the web site, the compensation committee charter is to appear as an appendix to the company's proxy or information statement under which it elects directors once every three fiscal years or, if it has been materially amended, in the next proxy or information statement under which the company elects directors. If the charter does not appear on the company's web site and is not included as an appendix in the current proxy or information statement, the company must identify the proxy or information statement to which the charter appeared as an appendix.

Liability Issues

The CD&A (but not the compensation committee report) is deemed "proxy soliciting material" and "filed" with the SEC and, therefore, subject to potential liability under Regulation 14A or 14C, as applicable, and Section 18 of the Securities Exchange Act of 1934, respectively. In addition, as "filed" information (which includes a detailed analysis of their own compensation), the CD&A is covered by the chief executive officer's and the chief financial officer's certifications under Section

302 under the Sarbanes-Oxley Act. Although the compensation committee report is deemed "furnished" rather than "filed," the chief executive officer and chief financial officer may "look to" the compensation committee report in providing their certifications.

How Should Companies Respond?

Companies and their compensation committees should consider taking the following actions as early as practicable in order to facilitate compliance with the new rules:

- Compensation committees should begin conducting a comprehensive review of the chief executive officer's, principal financial officer's and other named executive officers' performance for 2006.

- Convert the six issues related to the compensation elements and fifteen examples described above into a questionnaire that can be completed on a real time basis as the compensation committee makes compensation decisions.[3] This information then can be collected and summarized, together with any other factors that the committee deems to be material, and can be used in drafting the CD&A.

- With the disclosure factors in mind, review existing compensation arrangements and employment agreements with top executives and the company's policies regarding base compensation, perquisites, bonuses, stock-based compensation, severance and retirement benefits. Document the committee's compensation philosophy for discussion in the CD&A.

- Prepare a draft CD&A well in advance, not only of the filing, but also of year end, in order to be able to implement any changes in compensation arrangements deemed appropriate prior to year end (the new rules provide that CD&A should also cover actions regarding executive compensation taken <u>after</u> year end and, in appropriate situations, may need to discuss actions taken in prior years if needed to provide context to the current year disclosures).

- Companies that historically have not relied upon independent compensation consultants may want to consider retaining a consultant to assist them before they are fully committed to other clients.

[1]*The new rules also apply to Form 10-K and 10-KSB Reports for fiscal years ending on or after December 16, 2006, and provide that the applicable information may be incorporated by reference into a Form 10-K or 10-KSB Report from a timely filed definitive proxy or information statement.*

[2]*Named executive officers include: (i) all persons serving as principal executive officers and principal financial officers at any time during the last completed fiscal year, (ii) the next three most highly compensated executive officers serving at end of the fiscal year and (iii) up to two additional individuals who would have been included if such individual had been serving as an executive officer at the end of the fiscal year.*

[3]*Note that we are recommending something that goes beyond a "tally sheet," which focuses on compensation numbers rather than the reasons for the compensation decisions.*

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.