AGENDA

October 8, 2007

Preview of SEC Comp Guidance Reveals Catch–22

by Gregory Shulas

The SEC is going to force companies to provide more concise, plain English disclosures next year on their executive compensation. At the same time, the SEC will call on firms to provide more analysis and description of their pay setting process. That's according to a sneak peek of the guidance provided by John White, head of the SEC's Division of Corporation Finance, at a recent conference.

Balancing those two requirements, however, will be extremely demanding. In fact, many liken the task of being more concise and providing more analysis to mixing oil and water.

Companies fear that these two demands could be mutually exclusive because more analysis will in many cases require adding more information. This can lead to long-winded disclosures that run afoul of the SEC's plain English requirement.

"There are tensions emerging from this experience so far. There are going to be [continued] challenges," said Linda Rappaport, an attorney with Shearman & Sterling, at the conference, which was hosted by the Practising Law Institute.

White, however,argued that companies can simultaneously add analysis and write concise CD&As.

"We are asking for more disclosure, but somehow [to critics] that is anti-plain English because we are making the disclosures longer and longer. I disagree with that," White said. "When staff is asking for improved analysis, we are not asking the company to lengthen the disclosure… Keeping the plain English principles in mind, they can have a precise, effective discussion that [complies] with the rules."

One solution for companies is to cut out unnecessary information. "In two thirds of the filings that we looked at, disclosures included charts, tables and graphs that were not required," White says. "We did find them to be useful additions… They picked up the spirit and went ahead of the requirements of the rule."

Still, the guidance, which will be released this fall, calls on companies to stick to consistent graphic and layout format in comp disclosure documents and to tone down the use of side charts that may distract readers from the main Summary Compensation Table.

Another solution to the apparent catch-22 boards are facing is to cough up performance goals. Understanding performance goals is the "holy grail" for investors, said Ann Yerger, executive director at the Council of Institutional Investors. She expects most shareholders would be thrilled if companies focused more on targets in CD&As and scaled back the legalese. "No one will be upset if these things are shorter in length," Yerger adds.

Indeed, the SEC's current demand for more analysis is a direct result of companies' declining to release performance targets, says Alyce Halchak, a director at the law firm Gibbons.

In its new rules, the commission requested details on specific performance thresholds. But boards clammed up about them, citing confidentiality provisions protecting competitive information. The SEC recently followed up with comment letters again requesting the information.

“The SEC is cynical. There may be trade secrets, but there may be one of those things you can tell us… The SEC is saying, ‘Work around it. I know you say it is a trade secret, but we want you to tell us what your risk for failure is,’” Halchak says.

In the end, Halchak says boards should still place greater emphasis on disclosure rather than plain English when writing CD&As, given the former’s compliance role.

Companies that try to cut certain paragraphs or sentences for length reasons are sure to meet resistance from their lawyers, who prefer liability-proof documents over easy reading.

“We will not see concise CD&As for a while,” added Bonnie Hill, director at Home Depot, Yum Brands and The Hershey Company. “They are written by lawyers and their concern is over liability.”

Yet, bulking up on analysis could frustrate shareholders who claim lengthy CD&As have defeated the new comp disclosure rule’s purpose: to make it easier for shareholders to understand executive pay programs.

But some directors say making CD&As more efficient while providing more meaningful analysis to shareholders is definitely an accomplishable task. “While somewhat more challenging, it doesn't pose a major problem,” Roger Schipke, chairman of Legg Mason’s compensation committee, writes in an e-mail.