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Client Memorandum

Corporate and Securities

November 2006

The SEC's New Executive Compensation Rules: Compensation Discussion and Analysis

Background and Overview

On August 11, 2006, the Securities and Exchange Commission ("SEC") adopted final rules that substantially revamp the disclosure requirements for public companies with respect to executive and director compensation, related party transactions and other matters under the Securities Act of 1933 and the Securities Exchange Act of 1934. The release adopting the final rules is available on the SEC website at http://www.sec.gov/rules/final/2006/33-8732a.pdf.

This Client Memorandum is one in a series of Client Memoranda summarizing the final rules. The first Client Memorandum in this series summarized the highlights of the final rules. This Client Memorandum is intended to abstract the final rules as they relate to the new Compensation Discussion and Analysis ("CD&A") section that is required in proxy statements or Form 10-Ks, as well as to summarize best practice suggestions that we have compiled from a number of securities lawyers and compensation consultants.

The new CD&A is intended to be a narrative overview that provides context for a company's compensation disclosure. It also is intended to be a principles-based discussion like the current Management Discussion and Analysis (commonly known as MD&A). The CD&A should focus on analysis, rather than simply disclosing the facts relating to compensation matters. Drafting the CD&A will require a team approach and input from different departments, including Human Resources and Legal, as well as extensive involvement from the compensation committee.

Companies should begin preparing the CD&A early, because drafting the CD&A will be time intensive. Companies should consider circulating a schedule that sets forth a timeline for the CD&A drafting process. Furthermore, everyone involved in the drafting process, up to and including the Board of Directors, should understand that drafting the CD&A will be an iterative process. See *Tips for Drafting the CD&A* in the Appendix to this Client Memorandum.

Preparation of CD&A

The final rules include a list of six matters that must be discussed in the CD&A; however, we, along with a number of other securities lawyers, recommend that a company begin preparing the CD&A by focusing on main principles rather than using the list of six matters as a checklist to draft the CD&A. The main principles to focus on in drafting the CD&A are:

- What is the objective of the company's compensation packages?
- What are the compensation decisions?
- How do the decisions relate to the company's objectives?

Once these main principles are established, the process should focus on explaining material elements of compensation for named executive officers ("NEOs") in the CD&A, including the following six items required by the new rules:

- objectives of a company's compensation program;
- what the compensation program is designed to reward;
- each element of compensation;
- why a company chooses to pay each element;
- how a company determines the amount for each element (and, where applicable, the formula); and
- how each element and a company's decisions regarding that element fit into a company's overall compensation objectives and affect decisions regarding other elements.

The scope of the CD&A is designed to be comprehensive, and a company must address the specific compensation principles that it applies. Disclosure should not be boilerplate and should reflect the individual circumstances of a company. The final rules also provide that, to the extent material, narrative disclosure should be added following certain tables to supplement disclosure in the table. The CD&A should address the information contained in the tables and otherwise disclosed. The CD&A may refer to the tabular or other disclosures where helpful to its

discussion and analysis. Forward-looking information in the CD&A falls within the existing safe harbor for forward-looking disclosure.

The final rules include a non-exclusive list of matters potentially appropriate for a company to address in the CD&A. While each company should consider this list, it should not limit its CD&A to the examples provided in the final rules, but should instead draft a CD&A that is specific to the company and that reflects the company's compensation policies. It is not sufficient for a company to discuss a compensation program in isolation, it should discuss how compensation relates to business objectives.

Mark Borges, a leading compensation disclosure commentator, and other compensation consultants have suggested that companies should focus on five key issues in drafting the CD&A rather than using the SEC's list of examples as a starting point.

1. Describe and analyze the objectives, philosophies and policies of the compensation program.

How does the compensation program further the company's business and compensation objectives? Companies will need to take a multidisciplinary approach, with input from a number of individuals, including the compensation committee, the Chief Executive Officer ("CEO") and other executive officers, the head of Human Resources, compensation consultants and other outside advisors.

2. Describe and analyze the material aspects or components of the compensation program.

Companies should not merely draft a laundry list of the elements of their compensation program, but should instead address specific elements of their compensation program and explain why particular benefits are provided to executives. (***e.g.,*** Why were specific elements selected and how do they relate to compensation objectives? Why are retirement and post-employment benefits provided to executives? Is such compensation necessary? What perquisites are provided? Why are these perquisites provided?)

3. Describe and analyze performance-based compensation.

The rules emphasize the disclosure and analysis of performance-based compensation and call for a great deal of specificity. Companies should describe and analyze the specific elements of compensation that they use. (***e.g.,*** Why does the company use those elements as part of its compensation program? What does the company do to ensure that the elements in the compensation programs promote the company's business objectives?) Companies may omit specific performance targets involving confidential trade secrets or confidential commercial or other financial information if disclosure would result in competitive harm, but must instead discuss the difficulty or the likelihood of the executive meeting that target. Companies should document the rationale for any decision to withhold performance measures or targets from the discussion of performance-based compensation. Disclosure of a target level that applies a non-GAAP financial measure will not be subject to general rules regarding disclosure of non-GAAP financial measures, but a company must disclose how the number is calculated from audited financial statements.

4. Describe and analyze the equity compensation program.

Explain the process used by the company for granting options, including the reasons for selecting particular grant dates for awards and the methods, such as the exercise price, used to select the terms of the awards.

5. Describe how the compensation committee made its compensation decisions.

Discuss whether benchmarks were used to make compensation decisions. Discuss whether the compensation committee reviewed surveys or compensation data and explain why particular data was used. Discuss the role of executive officers in setting compensation. Discuss whether the compensation committee considered and rejected certain policies in making compensation decisions.

In order to support the required disclosure, it may be necessary for a company to make changes in the process used by its compensation committee. For example, John White, Director of the Division of Corporation Finance at the SEC, noted in a recent speech that if companies did not use tally sheets in the past, now would be a good time to begin using them. Companies also should ensure that the compensation committee has access to disclosure resources as it makes compensation decisions, not just at the time that the CD&A is being drafted.

After the initial draft of the CD&A has been prepared (taking into account the broad issues described above), companies should use the following list of examples provided by the SEC in the final rules to check the CD&A and ensure that all relevant matters were addressed:

- policies regarding allocations between long-term and currently paid out compensation;

- policies regarding allocations between cash and non-cash compensation, and among different forms of non-cash compensation;
- the basis for allocations of compensation to each different form of award (for long-term compensation);
- how the determination is made as to the timing for granting an award (for both equity-based and cash compensation);
- what specific items of corporate performance are taken into account in determining compensation policies and making compensation decisions;
- how specific elements of compensation are structured to reflect these elements of the company's performance and the executive's individual performance;
- what factors are considered in decisions whether to materially increase or decrease an executive's compensation;
- the effect of compensation or amount realizable from prior compensation in setting other elements of compensation (*e.g.*, how gains from prior option or stock awards are considered in setting retirement benefits);
- the impact of accounting and tax treatments of a particular form of compensation, including the treatment of the compensation under Section 162(m) of the Internal Revenue Code, as well as any other accounting or tax treatment that could be material to the company or the executive;
- the company's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership) and any company policies regarding hedging the economic risk of such ownership;
- whether the company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies);
- the role of executive officers in the compensation process;
- policies and decisions regarding the adjustment or recovery of awards or payments if the relevant performance measures upon which they are based are restated or otherwise adjusted in a way that would have reduced the size of the awards or payments; and
- the basis for selecting particular triggering events in post-termination agreements (*e.g.*, the rationale for using a single trigger in the event of a change of control).

The CD&A must cover compensation disclosure for the last fiscal year, like the Compensation Committee Report that was previously required. The CD&A also may require discussion of post-termination compensation arrangements, on-going compensation arrangements and policies that a company will apply going forward. Companies should ensure that the discussion of any post-employment arrangements is consistent with the description of these programs in the related narrative disclosures that accompany the tables. The CD&A also should cover actions regarding executive compensation that were taken after the end of the last fiscal year, including: the adoption or implementation of new or modified programs and policies, as well as specific decisions that were made or steps that were taken that could affect a fair understanding of the NEOs' compensation for the last fiscal year. It also may be necessary, in some cases, to discuss compensation for prior years in order to give context to the disclosure provided.

The CD&A should be precise enough to identify material differences in compensation policies and decisions for individual NEOs where appropriate. Officers may be grouped together where policies or decisions are materially similar. If policies or decisions for a NEO are materially different, compensation for that NEO should be discussed separately. For example, the compensation decisions for a newly hired NEO might be different and require separate disclosure than that provided for the other NEOs.

Option Disclosure in CD&A

In light of the amount of public attention that recently has been focused on option grant practices, particularly "backdating" and "spring loading," the SEC's adopting release makes it clear that companies must address matters relating to executives' option compensation in the CD&A, particularly as they relate to the timing and pricing of stock option grants. The SEC's stated intent is not to encourage or discourage the use of stock options or any other particular form of executive compensation.

The current rules regarding disclosure of executive stock option grants do not contain a line-item requirement with respect to information regarding programs, plans or practices concerning the selection of stock option grant dates or exercise prices. The final rules are intended to provide investors with more information about option compensation.

Companies will be required to address executives' option compensation in the CD&A, particularly as it relates to the timing and pricing of stock option grants. Several examples provided in Item 402(b)(2) in Regulation S-K illustrate how these types of issues might be covered in a company's disclosure. For example, how the determination is made as to when awards are granted could be required disclosure under Item 402(b)(2). Material information to be disclosed under CD&A might include the reasons a company selects particular grant dates for awards, such as for stock options. Other examples provided in Item 402(b)(2) further illustrate how the material information to be disclosed under CD&A might need to include the methods a company uses to select the terms of awards, such as the exercise price of stock options.

Timing of Option Grants

If a company had since the beginning of the last fiscal year, or intends to have during the current fiscal year, a program, plan or practice to select option grant dates for executive officers in coordination with the release of material non-public information, the company should disclose that in the CD&A. For example, a company might grant stock option awards while it knows of material non-public information that is likely to result in an increase in its stock price, such as immediately prior to a significant positive earnings or product development announcement. Such timing could occur in at least two ways:

- the company grants options just prior to the release of material non-public information that is likely to result in an increase in its stock price (whether or not the date of that release is a regular date or otherwise pre-announced); or
- the company chooses to delay the release of material non-public information that is likely to result in an increase in its stock price until after a stock option grant date.

A company also might coordinate its grant of stock options with the release of negative material non-public information. Again, such timing could occur in at least two ways:

- the company delays granting options until the release of material non-public information that is likely to result in a decrease in its stock price; or
- the company chooses to release material non-public information that is likely to result in a decrease in its stock price prior to an upcoming stock option grant.

The SEC believes that in many circumstances the existence of a program, plan or practice to time the grant of stock options to executives in coordination with material non-public information would be material to investors and this should be fully disclosed. In keeping with principles-based disclosure, companies should consider their own facts and circumstances and include all relevant material information in their corresponding disclosures. If a company has a program, plan or practice with respect to the timing of stock option grants, the company should disclose that the board of directors or compensation committee may grant options at times when the board or committee is in possession of material non-public information. Companies also might need to consider disclosure about how the board or compensation committee takes such information into account when determining whether and in what amount to make those grants.

While not an exhaustive list, the following are some elements and questions about option timing to which the SEC believes a company should pay particular attention when drafting the appropriate corresponding disclosure.

- Does the company have any program, plan or practice to time option grants to its executives in coordination with the release of material non-public information?
- How does any program, plan or practice to time option grants to executives fit in the context of the company's program, plan or practice, if any, with regard to option grants to employees more generally?
- What was the role of the compensation committee in approving and administering such a program, plan or practice? How did the board or compensation committee take such information into account when determining whether and in what amount to make those grants? Did the compensation committee delegate any aspect of the actual administration of a program, plan or practice to any other persons?
- What was the role of executive officers in the company's program, plan or practice of option timing?
- Does the company set the grant date of its stock option grants to new executives in coordination with the release of material non-public information?
- Does a company plan to time, or has it timed, its release of material non-public information for the purpose of affecting the value of executive compensation?

Disclosure also would be required where a company has not previously disclosed a program, plan or practice of timing option grants, but has adopted such a program, plan or practice or has made one or more decisions since the beginning of the past fiscal year to time option grants.

Determination of Exercise Price

In addition to the tabular disclosure, discussion in the CD&A would be required by companies that have a program, plan or practice of awarding options and setting the exercise price based on the stock's price on a date other than the actual grant date. As with the option timing matters, companies should consider their own facts and circumstances and include all relevant material information in their corresponding disclosures.

Companies should disclose other material terms of a stock option grant in the CD&A. For example, a company should disclose information regarding provisions in its option plans or practices it has followed for determining the exercise price by using formulas based on average prices (or lowest prices) of the company's stock in a period preceding, surrounding or following the grant date. In some cases, these provisions may increase the likelihood that recipients will be granted in-the-money options.

Furnished Compensation Committee Report

The final rules require a new Compensation Committee Report, modeled after the Audit Committee Report, which must state whether:

- the compensation committee has reviewed and discussed the CD&A with management; and
- based on the review and discussions, the compensation committee recommended to the board of directors that the CD&A be included in a company's Annual Report on Form 10-K and, as applicable, the company's proxy or information statement.

The Compensation Committee Report, unlike the Audit Committee Report, will be required to be included or incorporated by reference into the company's annual report on Form 10-K, so that it is presented along with the CD&A when that disclosure is provided in the Form 10-K or incorporated by reference from a proxy or information statement. The Compensation Committee Report will be furnished rather than filed. The Compensation Committee Report will be required only one time during any fiscal year. The name of each member of the compensation committee (or, in the absence of a compensation committee, the persons performing equivalent functions or the entire board of directors) must appear below the disclosure.

Filed Status of CD&A

In spite of a number of comments objecting to the Proposed Rules' treatment of the CD&A as soliciting material that constitutes part of the proxy statement and any other filing in which it is included or incorporated by reference, the SEC retained this approach in the final rules. The CD&A will be deemed filed with the SEC and it will be subject to Regulations 14A and 14C and to the liabilities of Section 18 of the Securities Exchange Act of 1934. The CD&A also will be covered by the certifications that principal executive officers and principal financial officers are required to give under the Sarbanes-Oxley Act of 2002 ("SOX"), since the CD&A and other required disclosure related to executive officer and director compensation of other matters must be included in or incorporated by reference into a company's Form 10-K. Therefore, companies may want the CD&A to be complete or near completion at the time the Form 10-K is filed so that the officers know what they are certifying. In practical terms, this means that the CD&A and other executive compensation disclosure may need to be substantially completed several weeks ahead of the normal proxy mailing date.

Responding to comments, the SEC indicated that the CD&A is not a report of the compensation committee although it discusses compensation policies and decisions. In certifying the CD&A, principal executive officers and principal financial officers will not need to certify as to the compensation committee deliberations. The principal executive officer and the principal financial officer, however, will be able to rely on the Compensation Committee Report in providing the certifications required by SOX.

Retention of Performance Graph

The final rules retain the Performance Graph, however, the SEC decided that the Performance Graph should not be presented as part of executive compensation disclosure. The content requirements for the Performance Graph remain the same, but have been moved to the disclosure item titled "Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters." The Performance Graph will no longer be a required proxy statement item. The Performance Graph will continue to be furnished rather

than filed and will not be deemed to be soliciting material under the proxy rules or incorporated by reference into any filing except to the extent that the company specifically incorporates it.

Effectiveness

The CD&A requirements become effective as follows:

- for Forms 10-K, for fiscal years ending on or after December 15, 2006;
- for proxy statements that are filed on or after December 15, 2006 that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006; and
- for registration statements (including post-effective amendments) that are filed with the SEC on or after December 15, 2006 that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

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For more information on the foregoing or other securities matters, please contact the authors of this client memorandum (Troy M. Calkins at 312-569-1150, Kimberly K. Rubel at 312-569-1133 or Noemi Flores at 312-569-1116), any member of the Gardner Carton & Douglas LLP Securities Practice Group, or your regular Gardner Carton & Douglas LLP contact.

APPENDIX

Tips for Drafting the CD&A

- Establish processes for the compensation committee to follow at its meetings throughout the year. The processes should be designed to assist companies with the content and drafting of the CD&A.

- Revise the Compensation Committee Charter to clarify in the charter that the committee is responsible for determining executive compensation and for describing and explaining it in the proxy statement.

- Consider providing training for compensation committee members, if necessary.

- Review disclosure controls and procedures to ensure that decisions made by the compensation committee and the factors, materials and tools that the committee utilized are recorded and communicated to the appropriate individual. Companies might consider having someone from the Legal Department attend compensation committee meetings to ensure that the relevant information for preparing the CD&A is being recorded.

- Develop a policy regarding the participation of the CEO and other executive officers in the processes of the compensation committee.

- Maintain a disclosure issues checklist that may be used by the compensation committee each time that it makes a compensation decision, including factors to consider and analytic tools to utilize before making the decision.

- Put together a CD&A team. Assign responsibility for preparing the first draft of the CD&A and for coordinating the completion of the CD&A.

- Review compensation committee materials, including minutes and materials distributed at meetings or in advance of meetings, such as compensation consultants' reports or presentations, benchmarking data, tally sheets, results of any wealth accumulation analyzes, internal pay equity audits, etc.

- Draft a mock-up now. It might be helpful to start with an outline and organize it along major topics, which can then be expanded to draft the actual CD&A. Early drafts of the CD&A should focus on the "big picture" or framework of a compensation program and details can be included as the year ends and the company determines who will be the NEOs. Companies might be able to use portions of last year's Compensation Committee Report in drafting the CD&A (*e.g.*, descriptions of the types of plans the company has and the compensation objectives that such plans serve), but companies should not merely mark-up last year's Compensation Committee Report to produce the CD&A.

- Use the 2005 compensation figures to begin preparing mock-ups of compensation tables. These mock-ups of tables should help in identifying matters that should be discussed in the CD&A.