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Client Alert

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SEC Updates Executive Compensation Reporting Guidance

Executive compensation disclosure requirements under the rules of the Securities and Exchange Commission are frequently a consideration when compensation decisions are made. The timing of any required disclosure is often an important consideration: can the disclosure be made in the company's next annual proxy statement, or must it be disclosed now in a Form 8-K report? The SEC Division of Corporation Finance has published updated guidance on compliance with the Form 8-K reporting requirements, including the requirements relating to executive compensation matters. Although the updated guidance does not contain any surprising changes in the views of the SEC staff with respect to executive compensation reporting, it does provide a roadmap that can help companies to:

- structure and administer compensation plans and programs,
- anticipate the timing and content of compensation-related disclosure, and
- administer disclosure controls and procedures and avoid late reports.

Because the staff interpretations are not subject to the procedural requirements that apply to agency rulemaking, they were effective upon publication on April 2, 2008.[1] The full text of the updated interpretations can be found on the SEC website at www.sec.gov/divisions/corpfin/guidance/8-Kinterp.htm.

Background: The 2004 SOX "Real Time" Reporting Rules and 2006 Amendments

The revised guidance replaces the Form 8-K interpretations in three previously published SEC interpretive documents: the staff's *Manual of Publicly Available Telephone Interpretations*, last updated in 1997; *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures*, issued in 2003; and *Form 8-K Frequently Asked Questions*, issued in 2004.

As part of the rulemaking required by the Sarbanes-Oxley Act, the SEC adopted extensive amendments to Form 8-K in 2004. These amendments expanded the events that were subject to mandatory reporting on Form 8-K and shortened the deadline for filing these reports. One of the most significant changes was the requirement to report entering into, materially amending or terminating compensation agreements and arrangements involving executive officers and directors. The 2004 amendments linked this reporting requirement to pre-existing

[1] The SEC subsequently published revisions to the new Form 8-K interpretations on April 3 and April 10, 2008.

rules governing the exhibit filing requirements for Form 10-K and 10-Q reports, under which nearly all such agreements and arrangements are deemed material and therefore became subject to mandatory Form 8-K reporting. One result of these amended requirements was an enormous increase in the number of Form 8-K filings related to compensation events, many of which were not necessarily material by other standards.

In 2006, the SEC significantly amended the Form 8-K reporting requirements for executive officer compensation when it overhauled its executive officer and director compensation disclosure rules. Disclosure of executive officer compensation events in Form 8-K reports was moved out of the general "material contracts" section and into a new section specific to executive officer and director events. Reporting of director compensation events was eliminated altogether except in connection with election of a new director. The SEC stated that the 2006 changes were intended to ensure "that Form 8-K capture[s] only events that are unquestionably or presumptively material to investors."

As a result of the 2004 and 2006 amendments, many parts of the SEC staff's published guidance no longer reflected current disclosure requirements. The updated SEC interpretations provide guidance on the staff's views concerning the current Form 8-K reporting requirements that were adopted in 2006 and eliminate references to the 2004 and earlier requirements. Although staff interpretations do not have the same legal weight as rules formally adopted by the SEC, they do reflect the views of the SEC staff concerning application of SEC rules and are therefore an important consideration in complying with SEC rules and structuring effective disclosure controls and procedures.

The SEC Roadmap for Navigating 8-K Compensation Disclosure

The updated Form 8-K interpretations relating to executive compensation will be among those of greatest interest, although the SEC's updated guidance covers a variety of other Form 8-K reporting requirements as well. In particular, the selected interpretations discussed below offer companies an opportunity to reassess their policies and procedures for administration of their executive compensation plans and programs. These interpretations make clear that relatively small changes in the nature and timing of compensation decisions may reduce the frequency of mandatory Form 8-K reporting, and therefore the time and expense devoted to preparation and filing of Form 8-K reports. In addition, because Form 8-K compensation disclosure is much narrower than the compensation disclosure contained in proxy statements, less frequent Form 8-K reporting is likely to facilitate presentation of compensation disclosure in a unified context in the company's proxy statement, rather than in Form 8-K reports that provide little context and duplicate isolated portions of the disclosure that will be contained in subsequent company SEC documents. Finally, the new SEC guidance may reduce the risk of inadvertent failures to file required Form 8-K reports, and may also reduce the likelihood that these Form 8-K reports distract from other Form 8-K filings that report events that are arguably more significant.

The distinctions in reporting obligations drawn by the SEC staff in the updated guidance depend in many cases on how a compensation plan has been structured

and the extent to which the plan has been previously disclosed. Viewed as a whole, the interpretations provide a roadmap for compensation structuring, administration and disclosure that is summarized in the following bullets, with our observations below.

- **Adoption of a new equity compensation plan triggers a reporting obligation, even if no awards are made at that time.**

- **Similarly, adoption of a new cash bonus plan triggers a reporting obligation, even if no specific performance criteria, performance goals or bonus opportunities are communicated to plan participants at that time.**

- **However, if adoption of a compensation plan is subject to stockholder approval, the reporting obligation is not triggered until stockholders approve the plan.** *(Questions 117.08 and 117.09)*[2]

Adoption of a material equity compensation plan or cash bonus plan in which named executive officers are eligible to participate by the company's board of directors or compensation committee requires current disclosure pursuant to Item 5.02(e) of Form 8-K. However, if the compensation plan is adopted subject to stockholder approval, the obligation to file a Form 8-K pursuant to Item 5.02(e) is not triggered until stockholders approve the plan. Similarly, if a reportable plan amendment or stock option grant is adopted subject to stockholder approval, the obligation to file a Form 8-K pursuant to Item 5.02 is not triggered until receipt of stockholder approval of the plan amendment or grant. Companies that fully report adoption of an executive compensation plan on a timely basis under SEC rules will be able to rely on the staff interpretations discussed below to defer reporting of certain compensation decisions.[3]

- **Establishment of specific performance goals and business criteria for plan participants after adoption of a material compensation plan has been disclosed in an Item 5.02(e) Form 8-K report does not trigger a second reporting obligation if the specific performance goals and business criteria are materially consistent with the previously disclosed terms of the plan.** *(Question 117.10)*

This interpretation, which reflects the revised standards of Item 5.02(e) of Form 8-K, is a significant change from prior Form 8-K requirements. If the specific performance goals and business criteria set for a performance period are materially consistent with the previously disclosed terms of the plan, no Form 8-K report is required when the specific goals and criteria provided in the plan are set for a performance period. For example, establishment of goals based on net income, EBITDA, FFO, return on equity or other measures would not trigger a reporting obligation if the selected goals and criteria were among those previously disclosed.

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[2] Citations in italics refer to the staff interpretations as published on the SEC website.

[3] Note that under certain circumstances, a company may be required to file a document as an exhibit to its next Form 10-Q or Form 10-K periodic report even if no Form 8-K report was triggered (for example, approval of a plan amendment that was not material for purposes of Item 5.02 of Form 8-K but must be filed under applicable exhibit filing rules).

This underscores the elimination of the prior Form 8-K requirements that have been a source of confusion that has led some companies to continue to file annual Form 8-K reports to disclose performance hurdles or targets outside the company's proxy statement. These Form 8-K reports present at least two potential problems. First, they often lack the depth necessary to put the compensation committee's deliberations into their proper context. Second, they may also lead the market to speculate on differences between the company's published earnings guidance and other forward-looking disclosures, on the one hand, and the company's incentive compensation targets or performance hurdles, on the other hand, which can result from differences between the internal budgets and forecasts upon which earnings guidance is based and the incentive compensation goals established by the compensation committee as part of the compensation process.

The practical result is that if a plan is drafted to include a suitably broad and flexible palette of performance and business criteria, and the plan is properly disclosed at the time of adoption, no Form 8-K will be required when the compensation committee subsequently (i) establishes specific performance targets or (ii) approves payment or distribution of awards upon achievement of the targets (see the second bullet following this paragraph). This is premised on these actions being "materially consistent with the previously disclosed terms of the plan."

This point is particularly significant when taken together with the SEC's position that, absent unusual circumstances, a company's Compensation Discussion and Analysis ("CD&A") in its proxy statement need only address performance targets and business criteria that relate to the year for which compensation is disclosed (*i.e.,* on a retrospective basis, rather than prospectively for the year in progress).[4] Accordingly, a properly designed incentive compensation plan for executive officers should allow companies to establish annual performance targets and business criteria without triggering disclosure requirements until actual performance for the year has been measured and the related compensation has been earned or awarded. The SEC guidance in this area, which makes clear that disclosure of specific *prospective* performance targets and business criteria related to incentive compensation programs is generally not required, brings welcome clarification to an area that has been the subject of past uncertainty.

- **No Form 8-K report is required when a cash bonus is paid pursuant to a provision of a previously disclosed compensation agreement that permits the compensation committee to award a cash bonus in an amount determined by the committee in its discretion.** *(Question 117.13)*

[4] As a practical matter, in addition to the required retrospective disclosure about prior year performance targets and the related compensation awards, it will generally be advantageous for compensation committees to use CD&A to signal shifts in the design or focus of incentive compensation programs. For example, if the compensation committee decides early in the year to move away from the current set of performance metrics (for example, EBITDA or cash flow) to a different set (for example, growth in revenue or market share), that year's CD&A should in most cases do two things. First, it should disclose the prior year's awards and the EBITDA or cash flow performance on which the awards were based, relative to the targets established at the beginning of the prior year. Second, it should disclose that the compensation committee has determined to establish performance targets for the current year that shift the performance/incentive focus to revenue or market share growth, and discuss the business or other reasons for this change.

Note that although no Form 8-K report is required for discretionary cash bonuses under these circumstances, disclosure of material information about the bonus must be included in the company's proxy statement as part of CD&A and the related compensation disclosures under Item 402 of Regulation S-K. Although the interpretation speaks only of cash bonuses, the principle may be equally applicable to increases in base salary.

- **Payment of a material cash award pursuant to a previously disclosed cash bonus plan does not trigger a reporting obligation if the payment was materially consistent with the previously disclosed terms of the plan (for example, because the performance criteria were determined to have been satisfied). However, payment of a material cash award where performance criteria were determined not to have been satisfied under a plan term that permits payment notwithstanding such a failure is not viewed by the SEC as materially consistent with the previously disclosed terms of the plan and would trigger a reporting obligation.** *(Question 117.11)*

The SEC staff takes the position that disclosure under Form 8-K Item 5.02(e) in this case will depend on the circumstances in which payment of the cash award is made. If the cash award is paid after the compensation committee determines that the performance criteria have been satisfied, no Form 8-K report would be required because the payment is materially consistent with the previously disclosed terms of the plan. On the other hand, if the payment is made in spite of a failure to achieve performance goals or targets based on discretion under the plan to pay awards notwithstanding such a failure, the SEC staff views the payment as not materially consistent with the terms of the plan. A Form 8-K report is therefore required to report the payment. The SEC answer to Question 117.13 does not address situations where the compensation committee approves a discretionary cash payment under another compensation plan or arrangement ("Plan 2"), rather than pursuant to discretion in the first plan ("Plan 1") to pay awards even though performance targets were not achieved. In cases where the compensation committee approves a discretionary cash payment under Plan 2, and the company has previously disclosed Plan 2, the interpretation in Question 117.13 should generally apply and no Form 8-K report should be required.

The practical result of this interpretation is that Form 8-K disclosure under the general circumstances described in Question 117.11 will often depend not only on the terms of the specific plan or agreement, but also on specifically which powers the compensation committee relies on and how its actions are characterized. Presentation of compensation information in the Summary Compensation Table may also be affected by the nature of the compensation committee's action. For example, if the committee chooses to make an award on a discretionary basis after a failure to achieve performance targets under Plan 1 as contemplated by Question 117.11, the bonus would most likely be required to be shown under the "Bonus" column rather than the "Non-Equity Incentive Plan Compensation" column of the Summary Compensation Table. Further, the discussion of the bonus in CD&A may be affected. The advantages and disadvantages of cash incentive plans designed as "formulaic," as opposed to discretionary, continue to be the subject of debate. The Form 8-K reporting requirement is only one of several factors that compensation

committees need to consider when deciding how much discretion to build into a plan or, in the case of a formulaic plan, whether to exercise discretion to pay bonuses after the fact if performance has fallen short of targets. Other considerations include whether the compensation committee believes that investors will make decisions based on whether awards are labeled as discretionary or formulaic, how much investors respect the judgment of the compensation committee in a volatile market where performance may need to be measured in ways not anticipated when a plan was adopted or targets were established and, in the end, what the real meaning of "pay for performance" is.

- **Form 8-K does not require disclosure of target levels for specific quantitative or qualitative performance-related factors, or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, if that disclosure would result in competitive harm for the registrant.** *(Question 117.12)*

The disclosure standard for Item 5.02(e) Form 8-K reports is consistent with treatment of similar information concerning specific quantitative and qualitative performance targets in proxy statement disclosure in Compensation Disclosure and Analysis under Item 402 of Regulation S-K (including Instruction 3 to Item 402(b) and Instruction 2 to Item 402(e)(1)). When the Division of Corporation Finance issued its report summarizing its review of executive compensation and related disclosures by 350 public companies last year, it noted that the Division issued "more comments regarding performance targets than any other disclosure topic," and frequently required companies either to "disclose the targets or demonstrate to us that disclosure of the particular targets could cause it competitive harm." This should be considered when determining whether a company can rely on the guidance in Question 117.12 and may provide further incentive for companies to seek to structure their compensation plans in a manner that will not require Form 8-K disclosure when specific performance goals are established.

- **Termination of a compensation plan or agreement in which named executive officers participate must be disclosed if termination constitutes a material amendment or modification.** *(Question 117.14)*

This interpretation would apply to actions that terminate plans, agreements or arrangements in which one or more named executive officers participate. However, consistent with other SEC staff interpretations, no Form 8-K report is required if a plan or agreement terminates or expires pursuant to its terms without any action on the part of the company or the participating executive officer.

The securities and corporate finance attorneys at Goodwin Procter keep current on these matters. We are available to help advise public companies and their officers and directors on specific issues as well as to provide educational presentations to help them understand and meet their responsibilities under both current and proposed rules and regulations. Please contact your regular Goodwin Procter attorney or any of the individuals listed below if we may be of assistance.

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