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THE CORPORATE communicator

www.swlaw.com

November 2007

contacts

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SEC Staff Guidance on Executive Compensation Disclosures

On October 9, 2007, the staff of the Division of Corporate Finance of the Securities and Exchange Commission (the "SEC staff") provided guidance to public companies on the new executive compensation disclosure rules which became effective in November 2006. The guidance was born out of the SEC staff's previously announced targeted review of the executive compensation disclosure contained in the 2007 proxy statements of 350 public companies. Contrary to some early reporting, the SEC staff specifically clarified that the selection of these 350 public companies did not involve a merit-based pre-assessment of such companies' executive compensation disclosure. The SEC staff appeared to select the companies in a manner consistent with its general periodic review process that contains an element of randomness, although the SEC staff's review was focused on large or mid-cap companies and intentionally sought to cover a broad range of industries.

In concert with the release of the SEC staff's report, John White, the Director of the Division of Corporation Finance, gave an address at the 2nd Annual Proxy Disclosure Conference in San Francisco and provided his own thoughts on the 2007 proxy season, which seemed to entail guarded optimism, seasoned with some continued criticism. While Mr. White opined that "as a whole, company efforts were quite admirable" and that "investors have been provided with the most comprehensive disclosure ever regarding how much public companies pay their executives and directors," he also made it clear that he was disappointed by the lack of "meaningful analysis" in the 2007 proxy disclosures. Or, as Mr. White stated, "Where's the analysis!"

Coupled with Mr. White's speech, we believe that public companies can glean the following two themes from the SEC staff's report:

- *Meaningful Analysis*: As Mr. White stated, companies need to focus on providing "meaningful analysis" on the "how" and "why" of specific executive compensation decisions. The Compensation Discussion and Analysis ("CD&A") should not include boilerplate disclosure, which many companies used year after year in connection with describing their compensation processes and philosophies in their compensation committee reports.
- *Presentation:* Companies should continue to search for ways to make their disclosure more (i) compliant with the SEC's plain English guidelines by using, among other things, overviews and layered disclosure and (ii) user-friendly by implementing tabular, graphic or other layout features which enhance an investor's ability to understand the disclosure.

SPECIFIC GUIDANCE

The SEC staff's guidance did get specific on certain matters, particularly related to CD&A disclosure, which was consistently included in the SEC staff comment letters. For convenience purposes, we have broken down this guidance into categories we call the "A," "B," "C" and "D" of proxy statement disclosure.

Analysis
Keeping in line with concentrating on the "how" and "why" of each specific executive compensation decision, the SEC staff has emphasized the need to provide clearer and more focused analysis on compensation decisions. In other words, companies should disclose in the CD&A "How they arrived at the particular levels and forms of compensation that they choose to award to their named executive officers?" and "Why they pay these particular forms and amounts of compensation?" In addition, in connection with these focusing efforts, companies should look to shortening their CD&As in other areas by removing extraneous disclosure on such things as the mechanics of philosophies or decisions. The SEC staff's report reiterated the SEC's previous recommendation that companies treat the CD&A similar to the overview that many companies utilize in their MD&A. For most companies, MD&A overviews are rarely longer than a couple pages, so this repeated guidance is consistent with other indications from the SEC that CD&As should generally be shorter.

Benchmarks
To the extent companies used comparative compensation information, many were asked to provide a more detailed explanation of how they used this information. In addition, companies were requested to provide more detail on the specifics of the peer group used and how the company's compensation compares to such peer group.

Change-in-Control and Corporate Governance
Change-in-control and termination arrangements. The SEC staff report indicates that many companies did not adequately discuss termination arrangements, including how such compensation fits into the overall compensation elements and philosophy and affected other compensation decisions. As was predicted by many commentators, the use of tabular disclosure regarding such agreements was encouraged by the SEC staff.

Corporate Governance. The SEC staff report indicated that many companies were asked to describe more specifically the role of their principal executive officers in making and setting compensation decisions.

Disclosure of Performance Targets and Differences in Decisions

Disclosure of performance targets. Many companies wrestled with this topic in 2007 and this promises to be a topic of apprehension for 2008. The SEC staff indicated that they issued "more comments regarding performance targets than any other disclosure topic" and that they found it difficult to understand how performance targets were used in compensation decisions. The SEC staff report reiterated that once a company determines performance targets are a material element of its compensation policies and decisions, then the company is required to disclose these performance targets unless it is able to demonstrate that disclosure of these targets would result in competitive harm. The SEC staff report also indicates that there are a number of situations that would require companies to discuss prior year and current year targets, which will likely be a source of consternation for many public companies.

Keep in mind that a company will likely, upon SEC review, be required to demonstrate to the SEC staff that the disclosure of such targets will indeed cause competitive harm. A company may seek confidential treatment for such explanation under SEC Rule 83. In addition, we note that if a company withholds disclosure of these targets on the basis of competitive harm, it needs to disclose with specificity the difficulty or likelihood of achieving the targets.

Difference in compensation policies and decisions. The SEC staff clarified that where policies or decisions on named executive officers compensation are materially similar, officers can be grouped together. However, where polices or decisions for individual named executive officers are materially different (e.g., the principal executive officer), companies should discuss these differences.

Practical Pointers

Based on the SEC staff report and Mr. White's address we offer the following practical suggestions:

- Many companies will continue to find a tension between heeding the SEC staff's guidance to keep the CD&A disclosure concise and getting comfortable that it has fully complied with all the disclosure requirements required to be included in the CD&A. We believe that accomplishing this goal will require concerted effort by companies and their counsel from an early stage of the drafting process. Mr. White's concluding thoughts of his speech recommended that before drafting the CD&A each key participant in a company's compensation decision-making process should provide a one-page bullet point list of the key "hows" and "whys" of compensation decisions. Mr. White also suggested that the company use these lists to draft the CD&A each year rather than trying to make the information in these lists conform to the prior year's CD&A format.

- It is unclear how effective each public company will be in satisfying the "competitive harm" justification for excluding specifics on their performance targets. It is clear that the SEC staff has made this a hot topic on its list of review items. Accordingly, when designing compensation packages and plans, compensation committees and boards of directors should keep in mind that their companies may have to disclose specific details on performance targets to the extent material to an understanding of the applicable compensation program and may want to adjust their packages and plans accordingly.

- Generally speaking, the SEC staff's comments to the 350 public companies only directed the recipients to address the staff's comments in subsequent filings (or in supplemental submissions to the SEC staff). However, now that the SEC staff has made a concerted effort to provide guidance on the new executive compensation disclosures it is likely that the SEC staff's expectations on compliance will be ratcheted up and companies should not assume that the SEC staff will be as accommodating in the future.

- Consistent with the SEC staff's policy, the comment letters and company responses related to these reviews will be posted on Edgar 45 days after completion of each review. Companies may be able to glean additional guidance from these individual comment letters and responses as they become available, particularly those in a company's specific industry or peer group.

Odds & Ends

In addition to our more detailed article about recent developments concerning Executive Compensation disclosure, we highlight a handful of actions and events that occurred in the last few months relating to SEC and IRS regulation, court decisions, and stock exchange regulation that should be of interest to a variety of readers. These items relate to:

- A proposal by the SEC to amend Regulation D;
- A delay in the NYSE's anticipated rule change to eliminate broker discretionary voting in director elections;
- A delay in the full implementation of IRS Code Section 409A until December 31, 2008; and
- A case providing guidance about how to preserve attorney-client privilege of tax documents relating to FIN 48 calculations

PROPOSED AMENDMENT TO REGULATION D

In August, the SEC proposed to revise the limited offering exemptions contained in Regulation D.

Regulation D, originally adopted in 1982, is used by companies of all sizes as a safe harbor for limited securities offerings without complying with the registration requirements of the Securities Act of 1933.

The most common exemption relied upon under the current rules is Rule 506, which provides companies an exemption from registration without any limit on the offering amount, so long as offers are made without general solicitation or advertising and sales are made only to "accredited investors"[1] and a limited number of non-accredited investors who satisfy a "sophistication" standard.

The SEC's proposed revisions include:

- <u>New Exemption for Large Accredited Investors</u>. The SEC is proposing to create a new exemption from the registration provisions of the Securities Act for offers and sales to "large accredited investors." A large accredited investor would be, in the case of a legal entity, an investor that has $10 million in <u>investments</u>[2] and, with respect to individuals, a person that owns $2.5 million in <u>investments</u>[3] or that has an annual income of $400,000 (or $600,000 with one's spouse). Although individuals meeting these standards

1 *Under the current rules, a natural person is considered an accredited investor if they have a net worth, or a joint net worth with their spouse, of $1 million or more or if they had an individual income in excess of $200,000 in each of the two most recent years or joint income with their spouse in excess of $300,000 in each of those years and have a reasonable expectation of reaching the same income level in the current year.*

2 *The current standard for legal entities is $5 million of <u>assets</u>.*

3 *The current standard for individuals is $1 million of net worth. The $2.5 million investments-owned standard for individuals is based on a similar standard the SEC proposed in December 2006 for individuals to invest in private pooled investment vehicles (e.g., hedge funds).*

would qualify as "accredited investors" and thus be eligible for offerings under the existing Rule 506 exemption, the benefit of qualifying for proposed "large accredited investor" exemption is that for offerings involving ONLY large accredited investors, companies would be able to publish limited advertising concerning the offering. The current and proposed version of Rule 506 prohibits the use of general solicitation and advertising.

For offerings and sales to only large accredited investors, a company could (at its option) publish an announcement of the offering that contains the following information:

- the name and address of the company;
- a brief description of the company's business (25 or fewer words);
- the name, type, number, price and aggregate amount of securities being offered;
- a definition of what "large accredited investor" means;
- any other suitability standards for prospective purchasers; and
- company contact information.

Such an advertising announcement must be written, but may be in electronic form (e.g., the internet). The advertisement, however, must prominently state that it is being made to large accredited investors only, that no money or other consideration is being solicited or will be accepted through the announcement and the securities have not been registered with, or approved by, the SEC.

The SEC made clear in its proposing release that securities issued pursuant to the proposed exemption for offerings to large accredited investors would qualify as "covered securities" and, thus, would qualify for preemption from state regulation under Section 18 of the Securities Act of 1933.

- Revise the Existing Thresholds for Accredited Investor Qualification. The SEC is proposing to add to additional accredited investor standards for individuals and entities. It is important to note that these standards are in addition to the existing standards, not a replacement of them.

Currently, individuals qualify as an accredited investor if they have a net worth above $1 million or if they have annual income above $200,000 (or $300,000 with their spouse). The SEC is proposing to add an alternative standard for individuals with $750,000 in "investments." Real estate held for personal purposes (e.g., personal residence) would be excluded from the definition of "investments."

For legal entities, the current standard is $5 million of assets. The SEC is proposing to add an alternative standard for entities with $5 million of investments. The utility of this alternative standard is not clear since every company with $5 million of investments would seem to qualify for the existing standard of $5 million of assets.

- Inflation Adjustments. The SEC is also proposing to adjust all of the thresholds for accredited investor and large accredited investor determinations for inflation.
- Shorten the Integration Period. Currently, Regulation D provides a safe harbor that offers and sales more than six months apart will not be considered part of the same Regulation D offering for purposes of determining the availability of a Regulation D exemption. The SEC is proposing to shorten this time period to 90 days.

BROKER VOTING FOR DIRECTOR ELECTIONS

The New York Stock Exchange has notified listed companies that its proposed rule eliminating broker discretionary for director elections will not be effective for the 2008 proxy season. The NYSE proposal is being delayed as the SEC considers it as part of a broader range of issues relating to the SEC's shareholder communications and proxy access proposals.

409A IMPLEMENTATION REPRIEVE

The IRS gave employers a meaningful reprieve by delaying certain plan amendment deadlines to comply with Code Section 409A.

- <u>Effective Date Deadline Delayed</u>. The IRS notice delayed the effective date of the final 409A regulations and plans must now comply in operation with the 409A regulations effective January 1, 2009.
- <u>Plan Documents Need Not Be Fully Compliant Until December 31, 2008</u>. As a general matter, employers need not adopt final 409A amendments to their plan documents until December 31, 2008. During 2008, deferred compensation arrangements will not violate 409A merely because plan provisions do not comply with Section 409A, provided the plan is operated in accordance with 409A and the plan is amended on or before December 31, 2008.
- <u>No W-2 Reporting for 2007</u>. The IRS also announced that deferred compensation that meets the requirements of Section 409A will not need to be reported on Form W-2 or 1099 for 2007.
- <u>Voluntary Compliance Program for Unintentional Violations of 409A</u>. The Treasury Department and IRS announced that they anticipate issuing guidance for a limited voluntary compliance program that will permit taxpayers to correct certain unintentional operational violations of 409A and in some situations eliminate or minimize the amount of additional taxes.

ATTORNEY-CLIENT PRIVILEGE— FIN 48 CALCULATIONS

In *United States v. Textron*, the IRS lost an important battle when a federal judge in Rhode Island ruled that the government did not have a right to internal tax documents belonging to Textron. The IRS and Justice Department had been trying to obtain tax-accrual work papers belonging to Textron, which included a legal analysis of transactions that could be challenged by the IRS. These workpapers also included an analysis by Textron lawyers of the company's legal weaknesses.

Communications between lawyers and their clients generally are exempt from discovery by adversaries, including governmental investigators. The importance of the *Textron* decision, though debated by scholars, lawyers and the government, is important as it provides a road map for creating and maintaining the privilege in the face of government challenge. Most experts agree that the IRS is reading FIN 48 disclosures as an aid in locating issues to challenge.

The court in *Textron* held that the tax accrual workpapers fell within the attorney-client privilege because they reflected the legal analysis of Textron's attorneys. The court also held that the tax accrual workpapers were protected by the more narrow work product doctrine, which applies to materials prepared in anticipation of litigation.

With respect to the work product privilege, the IRS unsuccessfully argued that the workpapers were prepared in the ordinary course of business by Textron in order to comply with GAAP by satisfying its auditor (Ernst & Young) that the company had sufficient reserves for contingent liabilities. In other words, the IRS argued that the workpapers were not prepared "in anticipation of litigation." The court, however, agreed with Textron's argument that "but for" the fact that Textron anticipated the possibility of litigation with IRS, there would have been no reason for it to establish reserves or to prepare the workpapers used to calculate the reserves in the first place.

The internal procedures followed by Textron played a large part in its successful defense. For example, Textron assigned one in-house accountant with sole responsibility for coordinating development of the tax accrual workpapers. In fact, the accountant would seal copies of the prior year's reserve calculations in confidential envelopes and distribute to selected attorneys in the tax department. These attorneys would update those parts of the analysis that they were specifically responsible for, including an analysis of the risks of litigation with the IRS. The attorneys would then return the updated analysis to the responsible accountant in the same sealed envelope. The reserve analyses were stored in a locked cabinet. The auditors were not involved in the process until near the end, and, although they were allowed to review the tax accrual analyses, they were not allowed to make copies for their own files.

In light of the *Textron* decision, companies should carefully consider their internal processes for developing their tax accrual reserves. *Textron* suggests the following best practices should be considered:

- Work relating to the tax accrual reserves should involve as a few employees as possible and should not be commingled with other responsibilities. This will help establish that the in-house team is functioning in a legal capacity, rather than a non-privileged business capacity.
- To the maximum extent possible, confidentiality should be maintained and separated from other non-privileged tasks, such as the preparation of the tax returns.
- Consider limiting the auditor's involvement to a review of the tax accrual workpapers only to the extent necessary to establish the adequacy of the accruals for tax uncertainties. This will help block a challenge that the workpapers are merely an accounting function, rather than privileged attorney work product.

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In our next issue, we will be providing our "Annual Meeting Season" edition that details new reporting requirements, issues and concerns relating to the 2008 Annual Report and Proxy Season along with links to our standard annual meeting forms and checklists.

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