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SEC Releases Final Rules on Executive Compensation Disclosure

After much fanfare, last month the SEC released its final rules on executive and director compensation disclosure (the "Rules"). The Rules require unprecedented and extensive disclosures about compensation policies and practices that will require significant analysis and attention by public company senior executives and directors. The Rules generally are effective for Forms 10-K and proxy statements filed for fiscal years ending on or after December 15, 2006, and thus will apply to disclosures of 2006 compensation in calendar year companies' 2007 proxy statements.

The Rules also require precise and detailed disclosures of stock option grants. This disclosure is intended to address the options backdating controversies now affecting more than 100 public companies.

Advance planning is key for senior management and compensation committees alike to evaluate how a company's proposed, current and past compensation policies and practices will be affected by and disclosed under the Rules. This is particularly true for several reasons:

- extensive amounts of new data will need to be captured, analyzed and discussed under the Rules;
- multiple meetings involving senior executives and directors will be needed to complete the required disclosures;
- many compensation committees may wish to develop and adopt new policies and procedures or more formally memorialize existing policies and procedures in order to provide clearer executive compensation disclosure; and
- compensation committees and management should assess the impact of the new disclosure requirements with regard to option grants in the current year.

A full copy of the Rules is available at: http://www.sec.gov/rules/final/2006/33-8732a.pdf). The following presents a brief summary of the Rules.

New "Compensation Discussion and Analysis" Section Required

General

An entirely new disclosure section called "Compensation Discussion and Analysis" ("CD&A") will be required. The CD&A is substantially different from its counterpart under the current rules, the "Compensation Committee Report." The CD&A is intended to put in perspective for investors the policies and decisions that led to the compensation decisions reflected in the tables and narrative disclosures set forth throughout the proxy statement. It is intended, in the spirit of the now familiar "Management's Discussion and Analysis of Financial Condition and Results of Operations," to provide the average stockholder with greater insight into executive compensation policies, plans and programs as seen through the eyes of management and the compensation committee.

Unlike the existing Compensation Committee Report, the CD&A will be deemed "filed" (not merely "furnished") and thus will be subject to the liability provisions of Section 18 of the Securities Exchange Act of 1934, and also will be covered by the Sarbanes-Oxley CEO and CFO certifications to the extent that the CD&A is incorporated by reference into a periodic report. In addition to the CD&A, a new scaled down Compensation Committee Report must be provided and the company's compensation committee will be required to state whether it reviewed the CD&A with management and whether it recommended to the board of directors that the CD&A be included in the proxy statement.

The CD&A is arguably the most significant departure from the current rules and will require significant input from senior management and a careful review by the compensation committee. In order to facilitate preparation of the CD&A companies should:

- consider preparing a "tally sheet" of executive compensation to help the committee understand each component of an executive's overall compensation;
- prepare mock-ups of the new disclosure tables for easy reference and to help ensure the CD&A discusses appropriately the compensation items disclosed in those tables; and
- start the planning process for preparing the CD&A early so as to allow for multiple meetings and drafts.

Disclosure Principles and Examples

The SEC has emphasized that the central purpose of the CD&A is to provide all material information about the compensation objectives and policies in order to put the new executive compensation tables into perspective. The purpose of this "principles-based" approach is to avoid overly-technical rules that could be narrowly read to limit the required disclosure. Consequently, the CD&A will be required to discuss all material elements of compensation for named executive officers, including such principles-based matters as:

- the objectives of the company's compensation policies;
- what behavior the compensation program is designed to reward;
- why the company chose to pay each element of compensation;
- how the company determined the amounts payable (including any calculation formula); and
- how each element of compensation relates to each other and to the company's overall compensation objectives.

In addition, the SEC provided a list of numerous examples of specific topics to be covered including:

- policies for allocating between long-term and currently payable compensation;
- policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- for long-term compensation, the basis for allocating compensation to each different form of award;
- for equity-based compensation, how the determination is made as to when the award is granted;
- what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- how specific elements of compensation are structured and implemented to reflect these items of the company's performance and the executive's individual performance;

- the factors considered in decisions to materially increase or decrease compensation;
- how compensation or amounts realizable from prior compensation (e.g., gains from prior option or stock awards) are considered 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;
- 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 basis for selecting particular events as payment triggers in compensation arrangements, including the rationale for selecting a single trigger for payment following a change in control;
- the role of executive officers in the compensation process; and
- the company's equity or other security ownership requirements or guidelines, and any company policies regarding hedging the economic risk of such ownership;

Stock Option Grant Practices

The Rules also require that the CD&A provide detailed disclosure about the timing of option grants, including discussions regarding:

- whether the company coordinates option grants with the release of non-public information;
- how the timing of option grants to executives fits in the context of grants to employees in general;
- the role of the compensation committee in the timing of option grants and how it takes into account non-public information in making option grants;
- any delegation by the compensation committee of the administration of option grants;
- the role of executives in the timing of option grants;
- whether the company sets the grant date of options in coordination with the release of non-public information, and whether the company plans to time (or has timed) its release of non-public information for the purpose of affecting executive compensation; and
- the rationale for the selection of option grant dates and methods used to select the terms of options grants.

The SEC has indicated that similar discussions related to director grants should also be provided in the narrative accompanying the new director compensation table described below. In addition, in view of the SEC's emphasis that the Rules are meant to provide a principles-based disclosure framework, companies should consider discussing these matters with regard to other equity-based compensation, such as stock appreciation rights, restricted stock and restricted stock units.

New Compensation Committee Report Requirement

The Compensation Committee Report (the "Committee Report") has been substantially revised and functions in large part as a backstop for the new CD&A, which now addresses many of the issues previously discussed in the current form of Committee Report in greater detail. The Rules now require that the Committee Report disclose two matters: first, whether the compensation committee has reviewed and discussed the CD&A with management; and second, whether or not the compensation committee recommends the CD&A be included

in the proxy statement and Form 10-K. CEOs and CFOs who must provide the Sarbanes-Oxley certifications that now relate to the CD&A are encouraged by the SEC to look to the Committee Report in doing so, particularly the recommendation by the committee that the CD&A be included in the Form 10-K and proxy statement.

Revised Summary Compensation Table

Total Compensation Must Now Be Calculated and Reported

The Summary Compensation Table ("SCT") disclosing executive officer compensation has been significantly revised and expanded. Most notably, the deemed total dollar value of all compensation paid to each "named executive officer" is required to be disclosed in a separate column, whereas in the past it was left to stockholders to assemble all of the elements of compensation and to calculate total compensation. Each of the elements of the total dollar value of all compensation is required to be disclosed in separate columns in the table. These columns include:

- salary;
- bonus;
- the grant date fair value of stock awards and options granted in the subject year determined under FAS 123R;
- non-equity incentive plan compensation;
- change in the actuarial present value of pension benefits and above-market or preferential earnings on non-qualified deferred compensation; and
- all other compensation.

We have attached tables showing the format of the SCT, as well as other required tabular disclosures required by the Rules, as an attachment to this Alert.

Revised Expanded Definition of "Named Executive Officers"

The Rules also now designate as "named executive officers" or "NEOs" the CEO and CFO in all instances and without regard to compensation, plus the three other most highly compensated executive officers. In addition, unlike the current rules, which look only to salary and bonus, the Rules require inclusion of the value of almost all forms of compensation (other than the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation) to determine the three most highly compensated executive officers. As a result, companies will need to track the compensation of more executives and in greater detail than they have in the past. In addition, up to two additional persons who served as executive officers during, but not at the end of, the fiscal year whose total compensation is higher than any of the three other most highly compensated executive officers discussed above must be included.

Total Dollar Value of Option Grants Included in Compensation

The Rules require that the deemed fair value under FAS 123R of all option grants in the current year be included in the calculation of total compensation without regard to the fact that most options will not be fully vested in the fiscal year that they are granted. As a result, the total compensation for some executive officers may appear quite substantial and variable from year to year depending upon the company's option grant practices. Companies may wish to consider how to best structure the vesting of equity awards to take this into account, as well as whether and how to best explain in the narrative section of the proxy statement the difference

between accelerated reporting of equity compensation under the new compensation rules and deferred financial reporting of such compensation in the company's financial statements under FAS 123R.

Catch-All for "All Other Compensation"

The Summary Compensation Table must also include the disclosure of "all other compensation." The SEC has emphasized in the Rules and related commentary that the only exception to this rule is a *de minimus* exception for perquisites in an aggregate of less than $10,000 per person. Specific examples of other types of compensation include:

- the total dollar value of any life insurance premiums;
- company contributions or other allocations to vested and unvested defined contribution plans;
- perquisites above the $10,000 threshold; and
- tax gross-up payments, and any severance payments.

Other than perquisites, which are subject to the more rigorous disclosure discussed below, each item in the category of "all other compensation" must be identified and quantified in a footnote if the amount involved is greater than $10,000.

Guidance on Perquisites

Although the SEC has intentionally avoided providing any bright line test as to what constitutes a perquisite, the Rules reiterate the SEC's two-stage test. Companies should first determine whether the item is "integrally and directly related to the performance of the executive's duties." If it is, then the benefit is not a perquisite without further analysis. However, if it is not, then a company must determine whether the item confers a direct or indirect personal benefit. If it does, then the benefit is a perquisite unless it is generally available on a non-discriminatory basis to all employees.

The Rules also lower the threshold for the reporting of perquisites from an aggregate of $50,000 to $10,000 per person. Thus, under the Rules, if perquisites exceed $10,000 for an individual, then each separate type of perquisite must be identified. In addition, if any perquisite has an individual value in excess of the greater of $25,000 or 10% of the value of total perquisites for the individual, then the value of each such perquisite must also be disclosed.

It is anticipated that the Rules application to perquisites will generate a significant amount of uncertainty and concern and may be the subject of further SEC guidance.

Rule on Non-Executive Officer Compensation Not Finalized

Under the proposed rules, companies additionally would have been required to disclose the compensation of up to three non-executive officers whose total compensation exceeded that of any NEO. In response to public comments that this rule (the so-called "Katie Couric Rule") would require disclosing competitive information about salaries of key non-management employees, the SEC proposed a revision to this rule such that it would only apply to companies that are "large accelerated filers" and then only to employees with responsibility for significant policy decisions within the company, a significant subsidiary or division. Unlike the other rules addressed in this Alert, this rule remains subject to additional public comment.

New Table for Grants of Plan-Based Awards

The Rules provide for a single table that combines disclosures for grants of non-equity and equity-based incentive awards, as well as any other stock and option awards during the fiscal year. This table requires disclosure of the following information related to grants of plan-based awards during the last fiscal year:

- the estimated dollar value of future payouts under non-equity incentive plan awards;
- the estimated number of shares of stock or options to be paid or vested under equity incentive plan grants;
- all amounts of any other stock or option plan-based awards;
- the exercise price of options granted; and
- the grant date of each equity award.

In addition, the Rules require up to two additional columns specifically designed to address the current options back-dating controversy:

- a column disclosing the date on which the compensation committee or the board of directors took action to grant each option awarded (the "Approval Date") if this date is different from the grant date of the option as determined under FAS 123R for accounting purposes; and
- a column disclosing the closing market price of the company's stock on each grant date (as determine under FAS 123R) where this price is higher than the exercise price of the option. A narrative description of the methodology used to set this exercise price will be required as well if it is different from the closing market price.

Expanded Outstanding Equity Awards Table; Option Exercises and Stock Vested Table

The Rules update the disclosure of equity awards outstanding at year-end to provide significantly greater detail than under the current rules. Whereas under the current rules the outstanding equity awards could be aggregated in a table requiring only four or five rows, the Rules require that companies disclose on a grant-by-grant basis the number of shares and options, the option exercise price, the option expiration date, the number of unvested shares and options, and the market value of unvested shares granted. Since this table includes all grants outstanding for all NEOs, in cases where officers have served long terms and received numerous grants, the table will be quite long. In addition, the Rules require footnote disclosure of the vesting dates of the awards, which will also add to the length of this disclosure and the time required to prepare it.

The Rules also require the disclosure, in a separate table, of the value that NEOs realized upon the exercise of stock options and SARs and the vesting of restricted stock during the last fiscal year. The calculation of value realized will be based on the difference between market price of the underlying security and the exercise or base price of the award.

New Retirement Plan Tables

The Rules will require two new tables for disclosing defined benefit retirement plans and non-qualified deferred compensation:

- the new Pension Benefits Table requires disclosure of the actuarial present value of each NEO's accumulated benefits under retirement plans. The table also must include all qualified and non-qualified defined benefit plans and supplemental employee retirement plans, but need not include defined contribution plans. This actuarial present value will be calculated as of the most recent pension plan measurement date used for the company's most recent audited financial statements and will use the same assumptions used for financial reporting purposes. This table will also require disclosure of the number of years of credited service (not just actual service) under the plan and any payments under the plan during the last fiscal year. A narrative disclosure providing the valuation method and material assumptions (or the relevant cross-reference thereto in the company's financial statements) and a discussion of the material terms of the plan is also required.

- the new Nonqualified Deferred Compensation Table requires disclosure of the following information regarding nonqualified deferred compensation plans for the fiscal year being reported: executive contributions; company contributions; aggregate earnings for the year (not just the above-market or preferential portion of such earnings as now reportable in the Summary Compensation Table); aggregate withdrawals; and the aggregate year-end balance.

A narrative disclosure of the material factors necessary to understand each plan is required as well.

Disclosure of Termination or Change in Control Benefits

The Rules require disclosure of termination and change-in-control benefits for NEOs, including a description of each type of change in employment status that would trigger the payment of benefits and the quantification of these benefits. The Rules clarify that, in quantifying these benefits, companies must assume that the event triggering the benefit occurred on the last business day of the most recently completed fiscal year and must use the stock price on that date for calculating the value of benefits. Since many change-in-control agreements contain multiple provisions that trigger the payment of benefits that vary depending upon the type of change in status (e.g., termination for cause, termination without cause, disability, termination following a change in control and constructive termination), compliance with this new disclosure requirement will require careful analysis. Companies should ensure that they timely commence the process of quantifying the benefits payable upon all such triggers for each NEO. Companies will also need to be prepared to explain the specific factors used to determine the appropriate payments and benefits.

Beneficial Ownership Disclosure

The Rules will require, for the first time, footnote disclosure in the beneficial ownership table of the number of company shares pledged as security by NEOs and directors. Companies should update their director and officer questionnaires and take other appropriate steps to be sure this information is captured. Moreover, the Rules require that this information be presented not only for each NEO, but also for all executive officers as a group. Accordingly, companies will need to gather information about pledged shares from all executive officers, not just the NEOs. Companies whose executive officers and directors have pledged significant amounts of their shares should consider the impact of this disclosure on investors.

New Director Compensation Table

The Rules require a new director compensation table ("DCT"), which is similar to the new Summary Compensation Table for named executive officers discussed above. Director compensation will, for the first time, be highlighted and prominently set forth in tabular form. In addition to requiring disclosure in the new table of such items as fees paid, equity awards, perquisites, and payments under certain charitable reward programs, the Rules will also require a footnote disclosure aggregating all option awards outstanding at fiscal year end. Disclosure is required only for the last completed fiscal year.

The Rules also require narrative disclosure of directors' compensation that includes any material factors necessary to understand the DCT. In this regard, companies should consider including narrative disclosure regarding their policies, practices and procedures with regard to all equity-based director compensation similar to that required for equity-based executive compensation.

Form 8-K Rule Changes

The Rules were designed by the SEC to clarify, and in some cases limit, the disclosures regarding executive and director compensation required under Form 8-K in order to focus on those items which the SEC believes are the most material compensation events. As a result of the changes, compensatory arrangements are no longer covered in Item 1.01 (i.e., Entry into a Material Agreement) of Form 8-K. Instead, Item 5.02 of Form 8-K has been expanded to address these arrangements, albeit in a more limited manner.

Item 5.02 focuses upon appointment and departure events and compensation arrangements for any director, any person that was a NEO during the company's previous fiscal year, and any principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions.

The primary events and disclosures covered by Item 5.02 of Form 8-K are as follows:

- the retirement, resignation, termination or appointment of directors and NEOs, as well as any principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions (as is currently required);

- the entering into, or *material* amendment of, any material plan, contract or arrangement in connection with the appointment of a new principal executive officer, president, principal financial officer, principal operating officer or person performing similar functions, in each case, to the extent such person participates in the plan, contract or arrangement;

- the entering into, or *material* amendment of, any material plan, contract or arrangement in connection with the election of a new director, to the extent such person participates in the plan, contract or arrangement; and

- the entering into, adoption or commencement, or material amendment or modification of, a *material* compensatory plan, contract or arrangement in which a company's principal executive officer, principal financial officer or other NEO participates, or a material grant or award under any such plan, contract or arrangement to one of such officers of the company. However, if the grants or awards are materially consistent with previously disclosed terms of the plan and the grants are disclosed the next time the company is required to provide new executive compensation disclosure, such as the company's next proxy statement, the company is not required to disclose those grants or awards.

The Rules modify the current requirements of Form 8-K to limit the disclosure of employment arrangements and material amendments to only those with "principal executive officers" (i.e., the principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer) and NEOs, and thus clarify that arrangements with other executive officers do not trigger a Form 8-K filing. Also, as noted above, the Rules clarify the SEC's position that new equity awards (such as options) for NEOs that are materially consistent with previously disclosed terms of the plan under which they were granted need not be disclosed in a Form 8-K. The Rules also expand on this position to exclude from required disclosure other awards (such as cash bonuses) that are materially consistent with the plan under which they were granted.

These modifications to Form 8-K apply to all reportable events occurring on or after November 7, 2006.

Corporate Governance Disclosure

The Rules also update existing disclosure regarding director independence and compensation committee activities and consolidate pre-existing corporate governance disclosure requirements into new Item 407 of Regulation S-K.

Director Independence

The new director independence disclosures include the following items:

- identify each director and nominee who is independent;

- describe, by specific category or type, any transactions, relationships or arrangements that were considered by the board of directors in determining whether applicable independence standards were satisfied but are not otherwise disclosed as related person transactions; and

- identify any audit committee, nominating committee or compensation committee members who are not independent.

Compensation Committee Disclosures

The Rules require disclosure of compensation committee processes and procedures related to executive and director compensation similar to that required for audit and nominating committees. In particular, a company must disclose:

- whether the compensation committee has a charter and, if so, whether it makes the charter available through its website or proxy materials;
- compensation committee processes and procedures for considering and determining executive and director compensation, including the committee's scope of authority, the extent to which the committee may delegate any authority, and, if so, what authority may be delegated and to whom, and any role of executive officers in determining or recommending the amount or form of executive and director compensation; and
- the role of any compensation consultants in determining or recommending the amount or form of executive or director compensation, including the identity of the consultants, whether the consultants were engaged directly by the compensation committee or by another person, and the nature and scope of their assignment.

Compensation committees should consider a review of their charter and other processes in the coming months to anticipate these new disclosures and to make any changes that are deemed appropriate. As one aspect of this review, the compensation committee and the company may want to consider reviewing relationships with any compensation consultants with a view toward the required disclosure.

New Disclosures Regarding Related Person Transactions

The Rules provide a principles-based framework that integrates and simplifies the related party disclosure requirements under the current rules for greater clarity and consistency. This framework requires the disclosure of transactions contained in revised Item 404(a):

- since the beginning of the registrant's last fiscal year (or any currently proposed);
- in which the company was or is to be a participant;
- where the amount involved exceeds $120,000; and
- in which any related person has or will have a direct or indirect material interest.

The Rules provide broad definitions for the terms used in this framework that are generally consistent with the current rules. Notable changes, however, include the increase in the threshold for reportable transactions from $60,000 to $120,000 and the expansion of "related persons" to include such persons as step-parents and step-children. The Rules also update specific exceptions for categories of transactions that do not require related person transaction disclosure.

In addition, the Rules require a description of the company's policies and procedures for review and approval of transactions with related persons, along with the identification of any such transactions that did not require a review under such policies. The Rules also require the company to disclose instances in which it did not follow its own policies and procedures with respect to the review and approval of related party transactions. Companies that have customarily addressed related party transactions on an ad hoc basis may wish to adopt an express policy addressing the process and standards for approval of future related party transactions.

Confidential Information

The Rules permit companies to omit disclosure of confidential company performance objectives (e.g., revenue targets or technology milestones) linked to bonus and similar compensation only if disclosure of this information would result in competitive harm. However, the Rules require that if a company elects to omit such confidential information it must disclose how difficult or likely it will be to achieve these performance objectives. This type of disclosure, which may involve implied projections about future company performance, will need to be carefully considered by senior management and the compensation committee.

Impact on Registration Statements

Registration statements filed by companies under the Securities Act of 1933 that are required to contain, or incorporate by reference, executive compensation disclosure (e.g., Forms S-1 and S-3, but not Form S-8) must comply with the Rules for fiscal years ending on or after December 15, 2006, even if the initial filing of the registration statement was made before that date.

What to Do?

Simply stated, advance planning is key. Companies should familiarize themselves now with the new Rules to ensure they are able to collect and analyze all of the information needed in order to comply with the Rules. Companies should also start preparing their proxies significantly sooner than in recent years in order to provide adequate time to complete the work necessary to comply with the Rules and consider any changes they might want to put in place.

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