

Client Alert

SEC Adopts Amendments to Executive Compensation Disclosure Rules

On July 26, 2006, the Securities and Exchange Commission adopted amendments to the rules requiring disclosure of executive and director compensation, related person transactions, director independence and other corporate governance matters, and security ownership of officers and directors.¹ While the SEC added new rules requiring disclosure of option grant practices and made certain modifications based on the record number of comments received, it appears that the final rules have been adopted substantially as proposed.² *Certain modifications to the proposed rules are highlighted in italics below.* The full adopting release with important details is expected to be published by the SEC shortly.

Executive and Director Compensation

The amendments will expand the currently required tabular disclosure and combine it with plain English narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, and three other highest paid executive officers and directors. The calculation of who is a named executive officer will be based on total compensation, *excluding earnings on nonqualified deferred compensation and changes in pension value.*

Compensation Discussion and Analysis

The amendments will require a new Compensation Discussion and Analysis (CD&A), which will be a “principles-based” overview in which the company explains its executive compensation policies and describes the most important underlying factors, similar in concept to MD&A for financial disclosure. The CD&A will be filed (rather than furnished) and will thus be a part of the disclosure subject to certification by a company’s principal executive officer and principal financial officer and Exchange Act liability.

A new Compensation Committee Report similar to the currently required Audit Committee Report will require a statement of whether the compensation committee has reviewed and discussed the CD&A with management and, based on this review and discussion, recommended that the CD&A

¹ See SEC Press Release No. 2006-123. A copy of the Press Release is available on the SEC’s website at www.sec.gov/news/press/2006-123.htm.

² For a summary of the proposed rules, see our Client Alert, “SEC Proposes Amendments to Executive Compensation and Related Party Disclosure Rules,” available on our website at www.chadbourne.com/publications.

be included in the company's annual report on Form 10-K or proxy statement. The Compensation Committee Report will be furnished (rather than filed).

The currently required stock performance graph will be retained, but it will now be included in annual reports to shareholders that accompany proxy statements relating to annual meetings at which directors are to be elected.

Tabular and Narrative Disclosure

A. Summary Compensation Table. The amendments make substantial changes to the current Summary Compensation Table, which will remain the principal medium for executive compensation disclosure. The Summary Compensation Table will be accompanied by narrative disclosure and a Grants of Plan-Based Awards Table that will help explain the information presented in the table. The Summary Compensation Table will include, in addition to columns for salary and bonus:

- separate columns reporting the dollar value for all stock and stock options, measured at grant date fair value, computed pursuant to FAS 123R;
- a column reporting the amount of compensation under non-equity incentive plans;
- a column reporting the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings (rather than all earnings) on nonqualified deferred compensation;
- a column showing the aggregate amount of all other compensation not reported in the other columns of the table, including perquisites. The threshold for disclosing perquisites will be reduced to \$10,000. Guidance for identifying perquisites will be provided in the adopting release; and
- a column reporting total compensation.

The SEC will re-propose a modified version of its proposed disclosure of compensation of up to three employees who are not executive officers. *The revised proposal would apply only to large-accelerated filers and would require disclosure of the total compensation (excluding earnings on nonqualified deferred compensation and changes in pension value) and job positions of each of a company's three most highly compensated employees, whether or not they were executive officers during the last completed fiscal year, whose compensation for that fiscal year was greater than that of any of the named executive officers included in the tables, except that employees having no responsibility for significant policy decisions within the company, a significant subsidiary, or a principal business unit, division or function would be excluded.*

B. Disclosure Regarding Outstanding Equity Interests. Disclosure regarding outstanding equity interests will include:

- an expanded Outstanding Equity Awards at Fiscal Year-End Table, which will disclose all equity awards (by individual grant) held as of fiscal year-end by each named executive officer; and
- the Option Exercises and Stock Vested Table, which will show amounts realized by named executive officers on equity compensation during the last fiscal year.

C. Retirement Plan and Post-Employment Disclosure. Retirement plan and post-employment disclosure will include:

- the Pension Benefits Table, which will require disclosure of *the actuarial present value* (rather than the proposed estimated annual retirement benefit) of each named executive officer's accumulated benefit under each pension plan, *computed using the same assumptions (except for the normal retirement age) used for financial reporting purposes under GAAP*;
- the Nonqualified Deferred Compensation Table, which will require disclosure with respect to nonqualified deferred compensation plans of executive contributions, company contributions, withdrawals, all earnings for the year (not just the above-market or preferential portion as required in the Summary Compensation Table) and the year-end balance; and
- a narrative description of any arrangement that provides for payments or benefits at, following, or in connection with any termination of a named executive officer, a change in responsibilities, or a change in control of the company, including quantification of these potential payments and benefits *assuming that the triggering event took place on the last business day of the company's last fiscal year and the price per share was the closing market price on that date.*

Disclosure Regarding Option Grants

The final rules are expected to require additional disclosure regarding option grant practices not previously included in the proposed rules, including clear tabular presentations of option grants disclosing:

- *the grant date fair value;*
- *the FAS 123R grant date;*
- *the closing market price on the grant date if it is greater than the exercise price of the award; and*
- *the date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date.*

If the exercise price of an option grant is not the grant date closing market price per share, the amended rules will require a description of the methodology for determining the exercise price.

The CD&A will also require enhanced narrative disclosure about option grants to executives. Companies will be required to analyze and discuss, as appropriate, material information such as the reasons a company selects particular grant dates for awards or the methods a company uses to select the terms of awards, such as the exercise prices of stock options.

Companies will be required to answer questions with regard to the timing of stock options such as:

- *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, for 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 the 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 will also be required where a company has not previously disclosed a program, plan or practice of timing option grants to executives, 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.

Similar disclosure standards will apply if a company has 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 or if the company determines the exercise price of option grants 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.

The adopting release is expected to provide additional guidance regarding disclosure of company programs, plans and practices relating to the granting of options.

In addition, on July 28, 2006, the PCAOB issued Staff Audit Practice Alert No. 1 providing guidance to auditors on the review of option grant practices, which guidance had been delayed at the SEC's request pending the adoption of the SEC rules.³

Director Compensation

Director compensation for the last fiscal year will be required in a Director Compensation Table (along with related narrative), which will be similar in format to the Summary Compensation Table.

³ A copy of Staff Audit Practice Alert No. 1 is available at www.pcaob.com/News_and_Events/News/2006/07-28_Release.pdf.

Related Person Transactions, Director Independence and Other Corporate Governance Matters

The amendments, with respect to disclosure of related person transactions, director independence and other corporate governance matters, were adopted substantially as proposed.

Security Ownership of Officers and Directors

The amendments requiring disclosure of the number of shares pledged by management and the inclusion of directors' qualifying shares in the total amount of securities owned were adopted substantially as proposed.

Form 8-K

The amended rules will modify the disclosure requirements in Form 8-K to require reporting of employment arrangements and material amendments thereto only for named executive officers and consolidate all Form 8-K disclosure regarding employment arrangements under a single item.

Effective Dates

- For Forms 8-K, compliance will be required for triggering events that occur 60 days or more after publication of the final rules in the Federal Register.
- For Forms 10-K, compliance will be required for fiscal years ending on or after December 15, 2006.
- For proxy and information statements and registration statements, compliance will be required for filings made on or after December 15, 2006 that are required to include executive compensation and related person transaction disclosure for fiscal years ending on or after December 15, 2006.

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For Additional Information

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