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## SEC ISSUES FINAL EXECUTIVE COMPENSATION DISCLOSURE RULES

By: [Margaret F. Murphy](#) and [Kelly C. Simoneaux](#)

On August 11, 2006, the Securities and Exchange Commission (“SEC”) issued final rules significantly revising the disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters. ([Click here](#) to link to the SEC’s release containing the final rules.) The changes take effect for proxy and information statements filed on or after December 15, 2006 that include executive compensation and related party disclosure for fiscal years ending on or after that date and for reports on Form 10-K and 10-KSB for fiscal years ending on or after December 15, 2006.

We have highlighted below some of the significant differences between current disclosure practices and the disclosure that will be required under the new rules. Not all of the new requirements described below will apply to small business issuers. Note that companies will now be required to prepare much of the compensation disclosure using plain English principles and the SEC has emphasized that “boilerplate” discussion should be avoided.

### Executive and Director Compensation

- *Named Executive Officers*—the new rules require compensation disclosure regarding the principal executive officer and the principal financial officer, and the three other most highly compensated executive officers based on total compensation in excess of \$100,000 (but excluding increases in pension values and above-market or preferential earnings on non-qualified deferred compensation).
  - *Compensation Discussion and Analysis (the “CD&A”)*—the new rules add the CD&A to proxy and information statements. The CD&A calls for a thorough discussion of the objectives and implementation of the company’s executive compensation programs and policies. The CD&A must include discussion of the company’s plans and practices relating to the granting of stock options, including the timing of option grants and the company’s methods for selecting terms of the awards (including the exercise price). The new rules provide a lengthy list of examples of the types of information required to be discussed in the CD&A. (See Appendix A for the text of new Regulation S-K Item 402(b), which includes the list of examples.)
- ⇒ The CD&A must discuss the past year’s compensation decisions and practices, but companies will also be required to discuss any post-termination and on-going compensation arrangements, executive compensation actions taken during the current year, as well as any prior year’s decisions or policies if necessary to give a better understanding to the other disclosures provided.

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- ⇒ The CD&A replaces the prior board compensation committee report on executive compensation, and is considered “filed” with the SEC (as opposed to “furnished”), thus making it subject to certification by the company’s principal executive officer and principal financial officer.
- ⇒ A new compensation committee report, which is considered “furnished” under the new rules, must be included and must state that the compensation committee has reviewed the CD&A with management and has recommended that it be included in the proxy statement and Form 10-K (similar in style to the current audit committee report).
- *Revisions to Summary Compensation Table (the “Summary Table”)*
  - ⇒ The Summary Table has been revised to add new columns detailing:
    - ◇ a single, total compensation figure for each of the named executive officers,
    - ◇ the dollar value of all stock-based awards, calculated to reflect the grant-date fair value in accordance with FAS 123R,
    - ◇ compensation received under non-equity incentive plans, and
    - ◇ the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation.
  - ⇒ More detailed disclosure of perquisites is required, provided the aggregate value of all perquisites is at least \$10,000, and the rules provide guidance as to the determination of whether a benefit constitutes a “perquisite.”
  - ⇒ The Summary Table must be accompanied by narrative disclosure and additional tables that will further explain the compensation information included in the Summary Table.
  - ⇒ The new rules permit companies to phase in these requirements, and restatement of prior years is optional.
- *Revised Tabular Disclosure*—the new rules revise the supplemental tabular disclosure to include the following tables, as applicable:
  - ⇒ The Grants of Plan-Based Awards table discloses grants to named executive officers during the last fiscal year, and must include the following information:
    - ◇ The FAS 123R grant date and grant date fair value,
    - ◇ The closing market price on the grant date if it is greater than the exercise price of any options granted (for example, if the exercise price is set using some methodology other than the closing price on the date of grant),

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- ◇ The date the compensation committee or full board of directors took action to grant the award, if that date is different from the grant date, and
- ◇ A description of the methodology used to determine the exercise price of options if other than the closing price on the date of grant.
- ⇒ The Outstanding Equity Awards at Fiscal Year End table must show amounts that may be received in the future upon exercise of options or vesting of restricted stock or other stock awards based on the stock price at fiscal year end, the number of securities underlying exercisable and unexercisable options, and the exercise prices and expiration dates for each grant of outstanding options (aggregation is not permitted).
- ⇒ A Nonqualified Deferred Compensation table must disclose executive and company contributions to nonqualified deferred compensation plans, withdrawals and all annual earnings (not just the above-market or preferential earnings disclosed in the Summary Table), as well as the year end plan balance.
- ⇒ The Option Exercises and Stock Vested table includes information on the number of options exercised and the number of shares of restricted stock that vested for each named executive officer during the last fiscal year and the aggregate value realized on exercise or vesting, as applicable.
- ⇒ The Pension Benefits table has been significantly revised, requiring disclosure of the actuarial present value of each named executive officer's accrued pension benefit, separated by plan and assuming payments are deferred to normal retirement age. These amounts are calculated using the same assumptions (except for normal retirement age) and measurement period as used for financial reporting purposes under GAAP.
- *Post-Employment Payments*—the new rules require extensive narrative disclosure regarding all written and unwritten arrangements that provide for payments in connection with a named executive officer's termination of employment, change in responsibilities or a change in control of the company. The disclosure must include, among other things, a description of the triggering events, an estimate of the payout each named executive officer would receive assuming the triggering event occurred on the last business day of the last fiscal year, the form of payment provided for, and any other material conditions or obligations applicable to the payment.
- *Director Compensation*—the new rules require tabular disclosure and accompanying narrative disclosure of director compensation during the last fiscal year only, similar in content to the Summary Table.

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## Other Noteworthy Provisions

- *Related Party Transactions*—the new disclosure requirements:
  - ⇒ Increase the dollar threshold for transactions required to be disclosed from \$60,000 to \$120,000.
  - ⇒ Require disclosure regarding the company’s policies and procedures for review, approval and ratification of related party transactions.
  - ⇒ Eliminate the distinction between indebtedness and other types of related party transactions.
- *Director Independence*—the new rules consolidate and update most of the disclosure requirements regarding director independence and corporate governance matters in new Item 4.07 of Regulations S-K and S-B.
- *Form 8-K*—the new rules (i) limit the disclosure requirements in Form 8-K concerning compensation arrangements and material amendments thereto to apply only to arrangements with directors or executive officers named in the Summary Table, and (ii) consolidate all disclosure regarding employment and compensation arrangements with executive officers under Item 5.02 of Form 8-K. Compliance with these changes will be required for “triggering events” occurring 60 days or more from the date the final rules are published in the Federal Register.
- *Security Ownership of Officers and Directors*—the beneficial ownership table will now include disclosure regarding the number of shares pledged by members of management and also include directors’ qualifying shares in the total amount of securities owned.
- *Performance Graph*—the performance graph will no longer appear in the company’s proxy statement as part of the disclosure regarding executive compensation, but will now appear in the company’s annual report on Form 10-K.
- *Compensation of Non-Executives*—the SEC has solicited comments on a re-proposed rule that would require certain narrative disclosure regarding the compensation of up to three non-executives whose total compensation is greater than that of the lowest paid named executive officer, provided such employees have responsibility for significant policy decisions. The SEC requests comments on various aspects of this proposal, including whether the rule should apply only to large accelerated filers, and the appropriate degree of identification of the employee (for example, is it sufficient to identify the employee’s position only).

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## What Should Companies be Doing

The new disclosure requirements will cause many companies to dramatically alter their proxy disclosure, as well as their internal schedules and procedures for preparation of the proxy statement. We strongly suggest that our clients begin reviewing last year's proxy statements now in light of the new rules, giving themselves sufficient time to gather the additional information that is required to be disclosed, revise disclosure in light of plain English principles, and re-format the sections of the proxy statement that will change. Also, board compensation committees will want to thoroughly review the new Compensation Discussion and Analysis, and have an opportunity to address some of the new disclosure requirements concerning the company's compensation philosophy and goals, which, depending on the company's past practices, may be significantly more detailed than the disclosure previously included in the compensation committee report. We are also working on an updated form of Directors and Officers Questionnaire, which will address issues raised by the new rules, and we are available to assist our clients with their evaluation of the impact these new rules will have on their particular disclosure practices.

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## APPENDIX A

### TEXT OF REGULATION S-K ITEM 402(b) Compensation Discussion and Analysis

1. Discuss the compensation awarded to, earned by, or paid to the named executive officers. The discussion shall explain all material elements of the registrant's compensation of the named executive officers. The discussion shall describe the following:
  - i. The objectives of the registrant's compensation programs;
  - ii. What the compensation program is designed to reward;
  - iii. Each element of compensation;
  - iv. Why the registrant chooses to pay each element;
  - v. How the registrant determines the amount (and, where applicable, the formula) for each element to pay; and
  - vi. How each compensation element and the registrant's decisions regarding that element fit into the registrant's overall compensation objectives and affect decisions regarding other elements.

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2. While the material information to be disclosed under Compensation Discussion and Analysis will vary depending upon the facts and circumstances, examples of such information may include, in a given case, among other things, the following:
  - i. The policies for allocating between long-term and currently paid out compensation;
  - ii. The policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
  - iii. For long-term compensation, the basis for allocating compensation to each different form of award (such as relationship of the award to the achievement of the registrant's long-term goals, management's exposure to downside equity performance risk, correlation between cost to registrant and expected benefits to the registrant);
  - iv. How the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
  - v. What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
  - vi. How specific forms of compensation are structured and implemented to reflect these items of the registrant's performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goal(s) or to reduce or increase the size of any award or payout), identifying any particular exercise of discretion, and stating whether it applied to one or more specified named executive officers or to all compensation subject to the relevant performance goal(s);
  - vii. How specific forms of compensation are structured and implemented to reflect the named executive officer's individual performance and/or individual contribution to these items of the registrant's performance, describing the elements of individual performance and/or contribution that are taken into account;
  - viii. Registrant policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment;
  - ix. The factors considered in decisions to increase or decrease compensation materially;
  - x. How compensation or amounts realized from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits);

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- xi. With respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payment(s) at, following, or in connection with any termination or change-in-control, the basis for selecting particular events as triggering payment (e.g., the rationale for providing a single trigger for payment in the event of a change-in-control);
- xii. The impact of the accounting and tax treatments of the particular form of compensation;
- xiii. The registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging the economic risk of such ownership;
- xiv. Whether the registrant engaged in any benchmarking of total compensation, or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- xv. The role of executive officers in determining executive compensation.

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*Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:*

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