

July 27, 2006

SEC Adopts Sweeping Changes to Executive Compensation Disclosure Rules

At an open meeting yesterday, the Securities and Exchange Commission adopted sweeping, much-anticipated changes to the rules regarding disclosure of compensation paid to executive officers and directors of public companies. The SEC proposed the new rules in January 2006.¹ A record number of comment letters, over 20,000, were submitted on the proposal.

Among other things, the new rules call for new tables showing a variety of compensation-related data, enhanced disclosure of pension, severance, and change in control benefits, lowered thresholds for reporting of perquisites, new disclosures about option grants aimed at addressing recent concerns about option granting practices, and tabular disclosure of director compensation. There will also be a new narrative section entitled "Compensation Disclosure and Analysis;" and the SEC adopted changes to rules regarding disclosure of related party transactions, amendments to Form 8-K reporting requirements for executive compensation matters, and new disclosure requirements relating to corporate governance issues.

Companies must comply with the new rules in proxy, information and registration statements filed on or after December 15, 2006, as well as in Forms 10-K and 10-KSB, in respect of fiscal years ending on or after such date. Thus, companies with a fiscal year ending on December 31 must use the new rules for their proxy statements in connection with the 2007 annual meeting. Companies are not required to restate information regarding executive compensation and related person transactions for prior years that was previously disclosed in accordance with the current rules. There are slightly different transition rules for investment companies. For current reports on Form 8-K, companies must comply for triggering events that occur 60 days or more after publication of the rules in the Federal Register.

Changes to Executive Compensation Disclosure

Although the text of the final rules and the accompanying adopting release are not available yet, at yesterday's open meeting the staff of the SEC noted several significant aspects of the new rules.²

New Compensation Discussion and Analysis Section. The rules require a new narrative section called Compensation Discussion and Analysis, or CD&A. The CD&A section is required to discuss the material factors underlying a company's executive compensation policies and decisions and is intended to provide a more comprehensive and meaningful discussion of the company's compensation policies than that called for by the current compensation committee report.

"Filed" Status of CD&A. Unlike the compensation committee report, the CD&A will be considered "filed," not "furnished." Consequently, disclosures in the CD&A will be subject to liability under the proxy rules and Section 18 of the Securities Exchange Act of 1934. Further, to the extent that the CD&A is incorporated by reference into a company's annual report on Form 10-K along with other executive

¹ Executive Compensation and Related Party Disclosure, Rel. No. 33-8655 (Jan. 27, 2006) ("Proposing Release"). The Proposing Release is available on the SEC's website at <http://sec.gov/rules/proposed/33-8655.pdf>.

² The SEC's press release regarding the open meeting is available at <http://www.sec.gov/news/press/2006/2006-123.htm>.

compensation information, it would be covered by the certifications required to be made in such reports by the principal executive officer and principal financial officer.

New Compensation Committee Report. Although the SEC had proposed deleting the compensation committee report altogether, the final rules retain it, albeit in a slimmed-down form. The revised version requires the compensation committee to report whether it has reviewed and discussed the CD&A with management and recommended including the CD&A in the company's proxy statement or annual report. The names of the members of the compensation committee would appear below the report, and the report would be deemed furnished, not filed, as under current rules.

Disclosures Regarding Option Grants. Answering the recent flood of media reports and governmental and investor scrutiny regarding stock option granting practices, the new rules impose several new tabular and narrative disclosures in this area. In a table showing grants of equity awards made in the most recent fiscal year, companies must highlight any grants having an exercise price below the market price on the date of grant by showing the two prices in separate, side-by-side columns and explaining in a footnote the methodology used to determine the exercise price. The table must also show the date the board or compensation committee took action with respect to an option grant, if such date differs from the official grant date of the option. Narrative discussion in the CD&A must also be included regarding the company's stock option granting practices and procedures, including how the board or compensation committee determines when equity-based awards are granted.

New SEC Guidance Regarding Option Grant Practices. The adopting release for the new rules will include new guidance for public companies in the area of option grant practices. This guidance is expected to address both the timing of option grants, including in relation to the release of material non-public information, and the setting of option exercise prices and related implications of setting an exercise price that differs from the market value of the underlying security on the option grant date.

Changes to Summary Compensation Table. Although its basic structure is intact, the Summary Compensation Table will change in a number of respects, including:

- The named executive officers to be covered in the table are the principal executive officer, the principal financial officer and the three other most highly compensated executive officers whose compensation exceeds \$100,000. This is a change from current rules, which define the named executive officers to be the chief executive officer and the four other most highly compensated executive officers.
- The amount used to determine whether an officer is one of the three other most highly compensated executives is that officer's total compensation in the most recent fiscal year, minus the amount of above-market earnings on deferred compensation and changes in the actuarial present value of accumulated pension benefits during such year (each reflected in two new columns in the table). Current rules count only annual salary and bonus.
- A new column must be added to show total compensation (expressed in dollars), equal to the sum of the amounts shown in the up to six other columns in the table. This is a noteworthy change from the current format, which includes some columns expressed in dollar amounts and one column expressed in number of securities, and, in any event, does not total the columns.
- All equity-based awards will be shown as dollar values, with the dollar amount of such awards based on their fair value on the date of grant calculated in accordance with FASB Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, or FAS 123(R). In a change from the proposed rules, for repriced awards, these columns need only include the incremental value of any awards that are repriced during the fiscal year, as opposed to the full value based on the new price.

- To facilitate determination of the named executive officers, a new column must be added showing the amount of above-market or preferential earnings on non-tax qualified deferred compensation and changes in the actuarial present value of the executive's accumulated pension benefits. The proposed rules would have required that all earnings on deferred compensation be counted, not just above-market earnings.
- For awards under non-stock incentive plans, the new rules require disclosure of the dollar value of all amounts earned during the year, as opposed to disclosing only amounts actually paid out under such plans as under the current rules.
- As reformatted by the new rules, a single column will capture all compensation not called for by the other columns in the table, replacing two similar columns in the current table which had led to confusion about where or whether to disclose certain items.

Perquisites. The new rules tighten the disclosure requirements for perquisites in a number of respects. In addition, the SEC indicated that it will provide interpretive guidance for determining what constitutes a perquisite. It is unclear whether this interpretive guidance will differ in any respect from the guidance offered in the SEC's proposing release. In that release, the SEC stated that an item is a perquisite if it "confers a direct or indirect benefit that has a personal aspect," regardless of whether it may be provided for some business reason or for the convenience of the company, unless it is "generally available on a non-discriminatory basis to all employees." The SEC also said in the proposing release that an item is not a perquisite or personal benefit if it is "integrally and directly related to the performance of an executive's duties."

Table on Plan-Based Awards. In addition to the new disclosures described above relating to option grants, this new table will include other details regarding performance-based awards (stock-based and non-stock-based) and other plan-based awards. The new rules eliminate the current requirement to show the potential realizable value of option grants under 5% or 10% increases in market value or the present value of each grant. In addition, the new rules eliminate the current requirement to show the percentage that a named executive officer's option grants represent of all option grants made during the year.

New Narrative Descriptions. The new rules make explicit what arguably is implicit under current rules by requiring a narrative description of material factors necessary to an understanding of the information disclosed in the Summary Compensation Table and the table showing grants of plan-based awards. The rules will set forth a number of examples of such material factors.

Changes to Table on Option Exercises and Stock Vesting. The new rules expand the current table on stock option exercises during the most recent fiscal year by also requiring the same information for awards of restricted stock that vest during the year. In addition, the table must now show the value realized by the named executive officer upon exercise of options and vesting of restricted stock. However, the final rules deleted the requirement in the proposed rules to show the grant date fair value of such awards as previously reported in the Summary Compensation Table in the year of grant.

Changes to Pension Table. The pension table has been substantially revised and will now require disclosure of not only more, but also more personalized, data about each named executive officer's pension benefits. The new rules require companies to disclose, as of the end of the most recent fiscal year, the actuarial present value of accumulated benefits under each defined benefit plan in which the named executive officer participates, based on the same methodology used to calculate such values for financial reporting purposes under GAAP. Companies would determine such amounts using current compensation levels and assuming the executive retires at normal retirement age under the plan. This approach represents a change from the proposed rules, which would have required companies to make estimates of each executive's annual retirement benefits.

New Table on Non-qualified Deferred Compensation. The rules require a new table disclosing contributions under nonqualified defined contribution and other deferred compensation plans in the last fiscal year by the named executive officers and by the company, as well as withdrawals during such year, all earnings for the year (not just above-market or preferential earnings), and the aggregate balances at fiscal year end.

Expanded Disclosure of Termination and Change in Control Provisions. Expanding upon current disclosure requirements, the new rules call for specific disclosures about written or unwritten arrangements to provide payments to named executive officers following or in connection with resignation, severance, retirement, termination, change in responsibilities of the named executive officer or a change in control of the company. Among other things, the new rules require management to make estimates of precise dollar amounts that would be required to be paid under such arrangements. In making such estimates, the company must disclose the material assumptions on which such estimates are based, but the rules provide that the company may assume that the triggering event occurs on the last business day of the most recent fiscal year and based on the company's stock price on such date.

Other Changes Adopted by the SEC

The SEC adopted a number of other changes to disclosure rules at yesterday's open meeting:

New Table on Director Compensation. The rules require a new table showing all compensation paid to directors. The components of this table are substantially the same as those in the Summary Compensation Table. However, only compensation for the last completed fiscal year need be disclosed, as opposed to three years of data in the Summary Compensation Table.

Disclosure Regarding Related Person Transactions. The new rules streamline and modernize the related person disclosure requirements, focusing the disclosure determination more on a materiality analysis and less on bright line standards. The disclosure threshold for related person transactions will move from \$60,000 to \$120,000. The changes in this area will also require companies to disclose any policies and procedures for review and approval of related party transactions.

Changes to Form 8-K. The SEC amended Form 8-K by moving compensation-related agreements and arrangements from Item 1.01 (material definitive agreements) to Item 5.02 (directors and principal officers). At the same time, Item 5.02 has been amended in a number of respects to clarify the scope of information required to be disclosed upon the occurrence of a triggering event under such item.

New Corporate Governance Disclosures. The SEC adopted additional disclosure requirements in the corporate governance area, most notably regarding the workings of the compensation committee, including, for instance, the role played by compensation consultants in determining the amount or form of executive and director compensation. The rules also add new disclosure requirements with respect to director independence, as well as consolidating a number of existing corporate governance disclosure requirements in one place under a new item.

Disclosure Regarding Pledges of Stock. Companies will now disclose, in the table on beneficial ownership of company securities, the number of shares of their stock pledged as security by named executive officers and directors.

Other Notable Departures from Proposed Rules

The final rules depart from the proposed rules in a number of other notable respects.

Compensation of Up to Three Employees Not Named Executive Officers. The SEC's proposal to require narrative disclosure of the total compensation of up to three employees whose compensation for the last completed fiscal year was greater than that of any of the named executive officers was strenuously opposed by many commenters. In response, the SEC decided to defer action on this aspect of the proposed rules and to repropose it in a modified form. It is expected that the reproposed version will limit the pool of potential employees covered by this requirement by excluding from its coverage employees who have no responsibility for significant policy decisions within the company. In addition, the reproposed rule would apply only to large accelerated filers (*i.e.* companies that, among other things, have more than \$700 million in unaffiliated outstanding equity market value).

Retention of Stock Performance Graph. Based on comments it received, the SEC retained the stock performance graph. However, the graph will be separated from the executive compensation disclosure and moved to Item 201 of Regulation S-K. As such, it will be required in annual reports accompanying or preceding proxy statements for annual meetings. We expect that the stock performance graph will continue to be deemed furnished, as it is under current rules.

Transactions Considered by Board in Making Independence Determinations. The proposed rules would have required disclosure of any transactions with independent directors not disclosed under Item 404(a) of Regulation S-K but which the board of directors considered in determining the independence of directors. Responding to concerns voiced by commenters, the final rule in this area was narrowed somewhat, and only requires disclosure of the specific category or type of any such transactions.

* * * * *

The final rules and related adopting release should be published in the next several weeks. We plan to issue a comprehensive client advisory following the publication.

David B.H. Martin
David H. Engvall

This information is not legal advice. Readers should seek specific legal advice before acting on subjects mentioned herein.

If you have any questions concerning this material, please contact the following members of our Securities Practice Group:

Bruce Bennett	212.841.1060	bbennett@cov.com
Edward Britton	+44.(0)20.7067.2119	ebritton@cov.com
Bruce Deming	415.591.7051	bdeming@cov.com
David Martin	202.662.5128	dmartin@cov.com

Covington & Burling LLP is one of the world's preeminent law firms known for handling sensitive and important client matters. This advisory is intended to bring breaking developments to our clients and other interested colleagues in areas of interest to them. Please send an email to unsubscribe@cov.com if you do not wish to receive future advisories.

© 2006 Covington & Burling LLP. All rights reserved.