

SEC Adopts Executive Compensation Rules

On July 28, 2006, the Securities and Exchange Commission (the "SEC") adopted a number of changes 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 Most of these changes impact the disclosure of such matters by operating companies. This update, however, is designed to highlight the new disclosure requirements that will affect registered investment companies.²

Disclosure Changes

In general, with these amendments, the SEC sought to increase the quality and usefulness of disclosure surrounding executive compensation. Registered investment companies are affected by two main disclosure areas: related person transactions; and director independence and corporate governance issues.

Related Person Transactions

Amended Item 404(a) of Regulation S-K under the Securities Act of 1933 articulates a broad principle for disclosure—it states that a company must provide disclosure regarding any transaction since the beginning of the company's last fiscal year, or any currently proposed transaction in which the company was or is to be a participant, where the amount in-

volved exceeds \$120,000; and in which any related person had or will have a direct or indirect material interest.

The amendments to Item 404(a) delete an Instruction, which stated that the "materiality of any interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case." The Instruction went on to state that the "importance of the interest to the person having the interest, the relationship of the parties to the transaction with each other and the amount involved in the transactions are among the factors to be considered in determining the significance of the information to investors."

In the Adopting Release, the SEC suggested that the Instruction was deleted because it was repetitive of the general materiality standard applicable to Item 404. The Adopting Release makes clear though that the amendment was not intended to change the materiality standard applicable to Item 404(a), where the materiality of any interest is determined on the basis of the significance of the information to investors in light of all the circumstances.³

Amended Item 404(a) also eliminates the Instruction which indicated that the dollar threshold in the Item was not a bright line materiality standard, which the SEC believes is "more consistent with a principles-based approach and will lead to more appropriate disclosure outcomes than application of the instruction that was eliminated."

¹ *Executive Compensation and Related Person Disclosure*, Rel. No. 33-8732A (Aug. 29, 2006) ("Adopting Release").

² For a broader overall view of the amendments, see *DechertOnPoint*, August 2006, Issue 46, prepared by our Employee Benefits and Executive Compensation Group available at http://www.dechert.com/library/EB_08-06_46.pdf.

³ Adopting Release, at n.413 (citing *Basic v. Levinson* and *TSC Industries v. Northway*).

In addition, the amendments:

- Call for disclosure if a company is a “participant” in a transaction, rather than if it is “a party” to the transaction, as “participant” more accurately connotes the company’s involvement
- Modify the \$60,000 threshold for disclosure to \$120,000 to adjust for inflation
- Include a defined term for “transaction” to provide that it includes a series of similar transactions and to make clear its broad scope
- Include a defined term for “related persons” and an expanded definition of “immediate family member”

Prior to the amendments, disclosure of indebtedness transactions was separately addressed in Item 404(c) of Regulation S-K. The amendments, however, incorporate the disclosure formerly required by Item 404(c) into the disclosure now required by Item 404(a). As the SEC notes in the Adopting Release, this makes the disclosure requirements for indebtedness and for other related person transactions congruent.

Director Independence and Corporate Governance Matters

The amendments also consolidate existing disclosure requirements with respect to director independence and related corporate governance matters. The SEC adopted new Item 407 of Regulation S-K, which updates disclosure requirements regarding director independence to reflect the SEC’s current requirements and current exchange and national quotation system listing standards. The highlights of the disclosure under this requirement will include:

- Disclosure of whether each director and director nominee is independent
- A description, by specific category or type, of any transactions, relationships, or arrangements not disclosed as a related person transaction that were considered by the board of directors when determining if applicable independence standards were satisfied

- Disclosure of any audit, nominating, and compensation committee members who are not independent
- Disclosure about the compensation committee’s processes and procedures for the consideration of executive and director compensation

It should be noted that registered investment companies have been required to disclose this information prior to these amendments and that the amendments do not significantly alter the disclosure required for registered investment companies.

Please see the attached Appendix, which highlights the differences between the old and new disclosure requirements, as applicable to registered investment companies.

Compliance Dates

Registered investment companies must comply with these disclosure requirements in initial registration statements and post-effective amendments that are annual updates to effective registration statements on Forms N-1A, N-2 (except those filed by business development companies), and N-3, and in any new proxy or information statements, filed with the Commission on or after December 15, 2006.

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New Executive Compensation and Related Person Transaction Disclosure Requirements Affecting Registered Investment Companies

Topic	Former Item	New Item	Changes
<u>Related Person Disclosure</u>	Items 404(a) and 404(c) of Reg. S-K	Item 404(a) of Reg. S-K	<p>The instructions to Item 404(a) were amended so that they no longer delineate what transactions are reportable or excludable from disclosure based on bright lines that can depart from a more appropriate materiality analysis. Instead, amended 404(a) consists of a general statement of the principle for disclosure of transactions with related persons, followed by specific disclosure requirements and instructions. Amended 404(a) also integrates the disclosure formerly required under 404(c) related to indebtedness transactions. Note that 404(a) does not require disclosure regarding indebtedness transactions of significant shareholders (or their immediate family members).</p> <p>Amended Item 404(a) changes the threshold amount from \$60,000 to \$120,000 (see below) and also changes the definitions of “transaction,” “related person,” “immediate family member” and “amount involved” (see below).</p> <p>Thus, Item 404(a) now requires a company to describe any transaction, since the beginning of the registrant’s last fiscal year, or any currently proposed transaction, in which the registrant was or is to be a participant and the amount involved exceeds \$120,000, and in which any related person had or will have a direct or indirect material interest.</p> <p>These revisions impact proxy materials of registered investment companies because Item 22(b)(11) of Schedule 14A cross-references Item 404(a).</p>
<u>Item 404(a) Definitions</u>			
“Transaction”	No definition	Instruction 2 to Item 404(a) of Reg. S-K	New definition: Includes, but not limited to, any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships (also includes indebtedness and guarantees of indebtedness).

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"Related person"	Certain parties are specifically listed in Item 404(a) of Reg. S-K, but there was not a definition of "related parties"	Instruction 1(a) to Item 404(a) of Reg. S-K	New definition: Any person who was at any time during the specified period for which disclosure under Item 404(a) is required: (1) any director or executive officer of the company and his or her immediate family members; and (2) if disclosure was provided in a proxy or information statement relating to the election of directors, any nominee for director, and the immediate family members of any nominee for director. The term also includes any security holder known by the company to beneficially own more than 5% of any class of voting securities or any immediate family member of that security holder, who was in such category when a transaction in which the security holder or family member had a direct or indirect material interest occurred or existed.
"Immediate family member"	Instruction 2 to Item 404(a) of Reg. S-K. Definition included only a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, and brothers and sisters-in-law	Instruction 1(a)(iii) to Item 404(a) of Reg. S-K	New definition: Expanded category, now includes child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and any person (other than a tenant or employee) sharing the household of a director, nominee for director, executive officer, or significant shareholder of the company.
"Amount involved"	Instructions 3 and 4 of Item 404(a) of Reg. S-K	Instruction 3 to Item 404(a) of Reg. S-K	<p>New definition: The dollar value of the transaction or series of similar transactions, which includes: (1) in the case of any lease or other transaction providing for periodic payments or installments, the aggregate amount of all periodic payments or installments due on or after the beginning of the company's last fiscal year, including any required or optional payments due during or at the conclusion of the lease or other transaction providing for periodic payments or installments; and (2) in the case of indebtedness, the largest aggregate amount of all indebtedness outstanding at any time since the beginning of the company's last fiscal year and all amounts of interest payable on it during the last fiscal year.</p> <p>New definition incorporates concept of indebtedness with integration of former Item 404(c) into amended Item 404(a).</p>

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<u>Exceptions to Item 404(a) disclosure requirements</u>	Item 404(a) of Reg. S-K	Instruction 5 to 404(a) of Reg. S-K	<p>Disclosure of an employment relationship or transaction involving an executive officer and any related compensation solely resulting from that employment relationship or transaction is not required if (1) the compensation is reported pursuant to Rule 402 of Regulation S-K; or (2) if the executive officer is not an immediate family member, and such compensation would have been reported under Item 402 as compensation earned for services to the company if the executive officer was a named executive officer, and such compensation had been approved, or recommended to the board of directors of the company for approval, by the compensation committee of the board of directors (or group of independent directors performing a similar function) of the company. The remaining exceptions remain unchanged.</p> <p>Note that Item 402 requires tabular and narrative disclosure of the compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors. The executive compensation disclosure is organized into three broad categories: compensation over the last three years; holdings of outstanding equity-related interests received as compensation that are the source of future gains; and retirement plans, deferred compensation, and other post-employment payments and benefits.</p>
<u>Disclosure threshold</u> of certain interests, transactions, and relationships of each incumbent or nominee director (who is not or would not be an “interested person” of an investment company within the meaning of Section 2(a)(19) of the 1940 Act).	<ul style="list-style-type: none"> • Schedule 14A – Items 22(b)(7), 22(b)(8), and 22(b)(9) • Form N-1A – Items 12(b)(6), 12(b)(7), and 12(b)(8) • Form N-2 – Items 18.9, 18.10, and 18.11 	<ul style="list-style-type: none"> • Schedule 14A – Items 22(b)(7), 22(b)(8), and 22(b)(9). • Form N-1A – Items 12(b)(6), 12(b)(7), and 12(b)(8). • Form N-2 – Items 18.9, 18.10, and 18.11. 	Disclosure threshold raised from \$60,000 to \$120,000.
<u>Disclosure regarding promoters</u>	Item 401(g)(1) of Reg. S-K	Item 401(g)(1) of Reg. S-K	Item 22(b)(11) of Schedule 14A cross-references Item 401(g) of Reg. S-K. Item 401(g) requires disclosure regarding the identity of promoters and transactions with promoters if the company has used a promoter at any time during the last 5 years. Previously, Item 401(g) did not require disclosure regarding the identity of promoters and transactions with promoters if a company had been organized more than 5 years ago, regardless of whether the company had a promoter in the past 5 years.

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<u>Security ownership disclosure</u>	Item 403(b) of Reg. S-K	Item 403(b) of Reg. S-K	Item 6(d) of Schedule 14A cross-references Item 403(b) of Reg. S-K. Amendment provides that a company must include a footnote to the currently required share ownership tables regarding the number of shares pledged as security by named executive officers, directors, and nominees. Amendments also require disclosure of beneficial ownership of directors' qualifying shares.
<u>Corporate governance related disclosures</u>	Item 7(e) of Schedule 14A required investment companies to furnish information required by former Item 22(b) in lieu of information required by Items 7(a) through (d)(1) and (d)(2)(ii)(D)	Item 7(e) of Schedule 14A requires investment companies to furnish information required by amended Item 22(b) in lieu of all information in Item 7. The information required by Item 7 and Item 22(b) has been relocated to new Item 407 of Reg. S-K.	Items 22(b)(15), (16) and (17) of Schedule 14A now include cross references to new Item 407 of Reg. S-K. The substance of the disclosure requirements has not been altered.
<u>Number of total Board meetings held during last fiscal year and information about attendance</u> <u>Security holder communication with board</u>	Items 7(f) and (h) of Schedule 14A	Item 22(b)(15)(i) of Schedule 14A	Item 22(b)(15)(i) of Schedule 14A cross-references new Items 407(b)(1) and (2) and (f) of Reg. S-K , and corresponds to the information required pursuant to former Items 7(f) and 7(h) of Schedule 14A.
<u>Nominating Committee information</u>	Items 7(d)(2)(i) and 7(d)(2)(ii) of Schedule 14A	Item 22(b)(15)(ii) of Schedule 14A	Amended Item 22(b)(15)(ii) of Schedule 14A cross-references Items 407(c)(1) and (2) of Reg. S-K, and corresponds generally to the information required pursuant to former Items 7(d)(2)(i) and 7(d)(2)(ii) of Schedule 14A.
<u>Disclosure regarding exemption from independence requirements for Nominating Committee members</u>	No requirement	Instruction to Item 22(b)(15)(ii)(B) of Schedule 14A	Requires disclosure of basis for conclusion that registered investment company may rely on exemption from independence requirements for nominating committee membership of its listing exchange or quotation system.
<u>Audit Committee disclosure (closed-end investment companies only)</u>	Item 7(d)(3) of Schedule 14A	Item 22(b)(16)(i) of Schedule 14A	Item 22(b)(16)(i) cross-references Items 407(d)(1) – (d)(3), and corresponds to the information required pursuant to former Item 7(d)(3). Note that Item 407(d)(1) provides that the audit committee charter need not be delivered to security holders so long as it is posted on the company's website.
<u>Disclosure regarding exemption from independence requirements for Audit Committee members</u>	No requirement	Instruction to Item 22(b)(16)(ii) of Schedule 14A	Requires disclosure of basis for conclusion that registered investment company may rely on exemption from independence requirements for audit committee membership of its listing exchange or quotation system.

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<u>Disclosure regarding directors who have resigned or declined to stand for re-election</u>	Item 7(g) of Schedule 14A	Item 22(b)(17) of Schedule 14A	No substantive change.

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