

SEC Proposes New Disclosure and Other Rules for Executive Compensation

For the first time in 14 years, the SEC has undertaken to significantly modify the executive compensation disclosure requirements in proxy statements, annual reports, and registration statements. In addition, the SEC's proposed rules add new requirements regarding related party transactions, corporate governance, and equity ownership among officers and directors.

The SEC's proposed rules were released on January 27, 2006, but will not be effective until the SEC publishes an adopting release in the Federal Register. However, by all indications, this proposal is intended to move quickly and is expected to be in place for the 2007 proxy season. In addition, employers seeking to comply with "best practices" regarding compensation disclosure may attempt to conform current filings to the proposed rules.

Highlights

As more fully described below, the proposal would substantially revise the disclosure requirements for executive and director compensation. A few of the more significant changes include the following:

- The Summary Compensation Table would be required to include *all* elements of compensation and would be revised to include a new column with a single figure for *total compensation*.
- The current Compensation Committee Report and Performance Graph would be eliminated and replaced with a comprehensive Compensation Discussion and Analysis that would describe the registrant's executive compensation policies and decisions.

- The proposal will require much more tabular disclosure (seven tables in all) that is intended to provide a clearer and more complete picture of total compensation.
- A new Retirement Plan Potential Annual Payments and Benefits Table and a new Nonqualified Defined Contribution And Other Deferred Compensation Plans Table will require much more extensive disclosure regarding post-termination compensation, including compensation triggered upon a change in control.
- The threshold for disclosing perquisites would be reduced from \$50,000 to \$10,000. In addition, the SEC proposal contains important guidance concerning what constitutes a "perquisite" that should be taken into account in doing *current* filings.

New Section: Compensation Discussion and Analysis

Under the SEC's proposed rules, a new section would be required entitled "Compensation Discussion and Analysis" (the "CDA"). Among the specific objectives of this section is to convey, in plain language, the objectives and implementation of a registrant's executive compensation programs, including post-termination and in-service arrangements. As a result of the improved narrative disclosure sought by the SEC, the proposed rule would eliminate the Compensation Committee Report and Performance Graph. Moreover, the SEC has indicated that the CDA would constitute "soliciting

material” (unlike the Compensation Committee Report and Performance Graph) and, accordingly, requires certification by the CEO and CFO under the Sarbanes-Oxley Act of 2002 and could subject registrants to liability for misrepresentation.

The CDA would describe the material elements of the registrant’s compensation for the named executives. According to the SEC, this discussion must be sufficiently precise to identify material differences in the compensation policies for individual named executives.

The SEC explained that the CDA should focus on the principles underlying executive compensation policies and decisions and should not contain any “boiler plate” discussion or be repetitive of the Summary Compensation Table and related disclosure. For this purpose, the CDA should consider, among other items: the objectives of the registrant’s compensation program, what it is designed to reward, how amounts payable are determined, policies for allocating between cash and non-cash rewards, what specific items of corporate and/or individual performance are considered, and what factors are considered in deciding to materially increase or decrease compensation. Registrants are not required, however, to disclose target levels of financial performance or any factors or criteria involving confidential information or which would place the registrant at a competitive disadvantage.

Summary Compensation and Supplemental Tables

Summary Compensation Table Changes

General Rules. The Summary Compensation Table would be revised to report on the previous three fiscal years’ compensation, whether paid currently or deferred, of each individual who served as either the principal executive officer (or Chief Executive Officer, or “CEO”) or the principal financial officer (or Chief Financial Officer, or “CFO”) at any time during the last completed fiscal year, and the three other highest paid officers at the end of the last completed fiscal year. The inclusion of the CFO is a change from the previous rule which required the Table to report the compensation of the CEO and four other highest paid officers. In addition, the proposed rules require a Director Compensation Table, similar to the Summary Compensation Table for executives, and a related explanatory narrative. Columns (c) and (d) of the exist-

ing rules, reporting Salary and Bonus respectively, are unchanged by the SEC’s proposed rules.

Change to \$100,000 Threshold for Reporting. The SEC’s proposal would modify the \$100,000 income threshold for determining whether an executive’s compensation is required to be disclosed. The current rules require reporting only if the executive’s salary (column (c)) and bonus (column (d)) exceed \$100,000 in the fiscal year. The proposed rules would require such disclosure if the executive’s Total Compensation (proposed column (c)), which includes, among other things, the value of restricted stock, options, incentives and perquisites during the fiscal year (as discussed below), exceeds \$100,000.

Proposed Column (c): Total Compensation. The Summary Compensation Table would be required to include a new column, reporting total compensation for each of the three preceding fiscal years. The proposed column is intended to address concerns of investors and consultants regarding the difficulty of computing aggregate amounts of compensation under the current disclosure rules.

The added column would facilitate year-to-year review by reporting the sum of Salary (proposed column (d)), Bonus (proposed column (e)), Stock Awards (proposed column (f)), Option Awards (proposed column (g)), Non-Stock Incentive Plan Compensation (proposed column (h)), and All Other Compensation (proposed column (i), which, as discussed below, includes any increase in actuarial value of pension plans and supplemental plans, earnings on nonqualified deferred compensation, and tax reimbursements or “gross-ups”).

Accordingly, the Total Compensation column would reflect the value of changes to an executive’s overall compensation package that would otherwise be apparent only by examining the specific items of compensation in the table. Since this column requires a quantification of all reported amounts, other columns of the table, reporting stock awards, options and other equity-based awards, would be reported at fair market value of the awards instead of the number of shares to which the award pertains.

Proposed Column (f): Stock Awards. The new column (f) proposed by the SEC would disclose awards that derive their value from the registrant’s equity, if such awards may be settled in company stock. The SEC clarified that stock awards subject to performance-based conditions would be reportable in this column

and not in proposed column (h), discussed below, relating to non-stock awards.

As indicated above, these awards must be valued at fair market value for purposes of calculating a named executive's total compensation. The SEC would specifically require fair market value to be determined under the Financial Accounting Standards Board's new accounting treatment for stock-based awards.¹ Accordingly, a stock-based award must be valued using a pricing model that takes into account the stock price on the grant date, the exercise price, the expected life of the award, the volatility of the underlying stock, the expected dividends on the stock, and the risk-free interest rate over the expected life of the award.

Proposed Column (g): Option Awards. Like stock awards, awards with option-like features, whether or not settled in stock, must be disclosed in proposed column (g) at their fair market value determined under FAS 123R. In addition, earnings on outstanding options would be included in column (g) and such earnings would have to be quantified in a footnote which reports whether the earnings were paid during the fiscal year, payable but deferred, or payable at a later date if earned in the fiscal year. Prior to the proposed rules, the SEC only required disclosure of such earnings if they were above-market or preferential.

In addition, the SEC would require reporting in column (g) of the total fair market value of repriced or modified options or stock appreciation rights, rather than only the incremental change in value reportable under FAS 123R.

Proposed Column (h): Non-Stock Incentive Plan Compensation. A registrant would report in column (h) amounts earned during the fiscal year that are not based on the price of the company's securities or may not be paid in stock. Amounts would be required to be reported in this column when the performance criteria are satisfied and the amount of compensation is earned. An unvested or unearned amount under such an incentive plan would be reported in the Grants of Performance-Based Awards Table for the fiscal year in which it was granted, as discussed below.

Changes to Column (i): All Other Compensation. Under the proposed rules, column (i) would include dis-

closure of all compensation not properly reported in the other columns of the table. This would include items reported under the current rules as Other Annual Compensation (column (e)). In addition, the new rules would require reporting in proposed column (i) of the aggregate increase in actuarial value of defined benefit pension plans and supplemental plans accrued during the year, all earnings on nonqualified deferred compensation, amounts paid or accrued to a plan or arrangement in connection with any termination of employment or change in control, the value of any life insurance premiums paid for the benefit of an executive, reimbursements or "gross-ups" of an executive's tax liability and discounts on executive purchases of registrant or subsidiary securities.

The current requirement that the registrant report company contributions to defined contribution plans in this column is unchanged in the proposed rules. Except for perquisites and personal benefits (discussed below), any item in the All Other Compensation column that exceeds \$10,000 would have to be separately identified and quantified in a footnote.

Regarding perquisites or other personal benefits previously required to be reported in the All Other Compensation column, the SEC's proposed rule would lower the aggregate threshold for reporting from \$50,000 to \$10,000. The SEC's interpretive guidance clarifies that an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties. Instead, a perquisite or personal benefit confers a direct or indirect benefit that has a personal aspect and is not generally available to all employees.

In addition, the SEC provides the following examples of perquisites requiring reporting: club memberships not used exclusively for business entertainment purposes, personal financial or tax advice, personal travel using vehicles owned or leased by the registrant, personal travel otherwise financed by the registrant, personal use of other property owned or leased by the registrant, housing and other living expenses, security provided to an executive during travel or at the executive's residence, and discounts on products or services not available generally to all employees of the registrant. Any perquisite or personal benefit with a value \$10,000 or more must be identified in a footnote, and if the value exceeds the greater of \$25,000 or 10% of the total perquisites and personal benefits of the executive, must also be quantified.

¹ Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, (FAS 123R).

Supplemental Annual Compensation Tables

Following the Summary Compensation Table, the proposed rules would add two new tables (and accompanying narrative, as discussed below) to report additional compensation information for the last fiscal year.

New Table: Grants of Performance-Based Awards

The Grants of Performance-Based Awards Table would report shares of performance-based stock, stock units, and other types of awards that do not have option-like features. The proposed rules clarify that awards are to be considered performance-based if they are subject to either a performance condition, or a market condition, as those terms are defined in FAS 123R. For any such grants, the table would include the number of such rights awarded as well as the dollar value or number of shares estimated for future payout. Regarding future payout, the table specifically requires reporting of the minimum amount payable for a certain level of performance (the “threshold”), the amount payable if specified targets are reached (the “target”) and the maximum payout possible under the plan (the “maximum”).

New Table: All Other Equity Awards

The All Other Equity Awards Table would report all other equity-based compensation awards granted that are not tied to the registrant’s stock price or other measures of performance. Each such award to an executive should be entered on a separate line in the table and the material terms, for example, the date of exercisability, number and nature of any tandem instruments, reload feature, or tax reimbursement feature, must be described in footnotes to the relevant grants. In addition, Options or SARs granted in connection with a repricing transaction would require disclosure in the All Other Equity Awards Table along with a separate footnote describing the material terms applicable to such a grant.

Narrative Disclosure to Summary Compensation Table and Supplemental Tables

General Rules. The SEC’s proposed rules would require narrative disclosure following the Summary Compensation Table, the Grants of Performance-Based Awards Table, and the All Other Equity Awards Table. (Additional narrative disclosure is required in

connection with the Post-Employment Compensation disclosure, discussed below.)

The narrative is intended to provide context to the quantitative amounts shown in the tables and may require disclosure, for example, of:

- Material terms of written or unwritten employment agreements
- Terms related to the repricing of options or stock-based awards (in lieu of the 10-year repricing table currently required)
- The formula, criteria, conditions, vesting schedule, dividend rights, and applicable rate of awards (including whether any rate is preferential), and whether any performance targets were waived with respect to performance-based awards
- Any assumptions underlying the increase in actuarial value of defined benefit plans and provisions for determining earnings in non-qualified defined contribution plans

Additional Employees May Require Narrative Disclosure. Finally, the SEC is proposing to require disclosure for up to three employees who were not executive officers in the last fiscal year, but whose total compensation was greater than that of any of the named executive officers. Registrants would have to provide such employees’ job titles and total compensation, but would not need to identify them by name.

Exercises and Holdings of Previously Awarded Equity

The proposed rules would incorporate two new tables showing the amounts of awards from prior fiscal years that remain outstanding as well as the exercise or vesting of prior year awards during the reported fiscal year.

New Table: Outstanding Equity Awards at Fiscal Year-End

This table would require disclosure of the in-the-money amount of options, stock appreciation rights and other instruments calculated by determining the difference at fiscal year end between the market price of the underlying security and the exercise or base

price. The value of the non-vested portion of other awards such as restricted stock, restricted stock units and similar interests, would be calculated by multiplying the closing market price at the end of the fiscal year by the respective number of shares or units outstanding. In addition, registrants would be required to disclose in a footnote the expiration and/or vesting dates of awards and, in the event an option expired after the end of the fiscal year but before the disclosure is made, the registrant would be required to disclose whether the option was exercised.

New Table: Option Exercises and Stock Vesting

The SEC would require a table to show the exercise of options or vesting of other stock awards during the fiscal year. To help reduce the potential confusion associated with double-counting, however, the table would include the grant date fair market value, as disclosed in the Summary Compensation Table for the year in which they were granted.

Changes to Option/SAR Grants Table

The SEC proposes to eliminate columns (f) and (g) of the Option/SAR Grants in the Last Fiscal Year Table that require disclosure of the potential realizable value under 5% or 10% increases in present value, respectively. However, in lieu thereof, the SEC's rules would require disclosure of all earnings on outstanding equity-based awards (as discussed above). Prior to the proposed rules, the SEC only required disclosure of such earnings if they were above-market or preferential.

Post-Employment Compensation

The SEC's proposed rules require two new tables to report post-employment compensation: a Retirement Plan Potential Annual Payments and Benefits Table and a Nonqualified Defined Contribution and Other Deferred Compensation Plans Table. Each of these tables would also require a separate narrative section to add context to the quantitative disclosure in the tables.

New Table: Retirement Plan Potential Annual Payments and Benefits

This table would require disclosure, on a separate line for each such plan, of the amount that may be pay-

able upon early or normal retirement age under the registrant's defined benefit plans. The amount of potential payments disclosed should reflect the form of benefit currently elected by the named executive. A footnote would be required to explain the executive's benefit election. If the named executive is not yet eligible for retirement, the amounts required to be disclosed in this table should be calculated assuming that the executive earns the amount of compensation reported for the fiscal year in all successive years.

New Table: Nonqualified Defined Contribution and Other Deferred Compensation Plans

To give a more complete picture of post-employment compensation, the SEC would add a table and accompanying narrative regarding nonqualified deferred compensation. The table would include the contributions (whether by the executive or the registrant), withdrawals, earnings, and account balances of deferred compensation plans or arrangements. Since the Summary Compensation Table requires reporting of earnings on deferred compensation in proposed column (j), the Nonqualified Defined Contribution and Other Deferred Compensation Plans Table would require a footnote of the extent to which amounts reported are duplicated in the Summary Compensation Table for the applicable fiscal year as well as previous fiscal years.

The narrative accompaniment to the table would include, for example, the types and limits of compensation to be deferred, the measures for calculating earnings, and the material terms with respect to payouts, withdrawals and other distributions.

New Narrative Disclosure: Other Potential Post-Employment Payments

The SEC is also proposing narrative disclosure of specific aspects of written or unwritten arrangements providing for payments triggered by an executive's resignation, severance, retirement, or other termination, including termination as a result of a change in control of the registrant. This section would require disclosure of the circumstances that could trigger payment, quantification of estimated payments and benefits (including the form of payment), factors used to determine the amount of payment, any material conditions or obligations on such payments (including restrictive covenants), and any other features necessary for an understanding of these arrangements.

Proposed Revisions to Form 8-K and the Period Report Exhibit Requirements

Under the current Item 1.01 of Form 8-K, registrants must file as exhibits employment compensation arrangements, including employment agreements and compensation plans to which any named executive officer is a party, other management contracts or plans unless immaterial in amount or significance, and any compensation plan or arrangement that may award equity which has not been approved by shareholders. The SEC's proposed rules would eliminate this requirement from Item 1.01 and instead require this disclosure under Item 5.02, which currently requires disclosure in the event specified executive officers separate from the registrant or, alternatively, new specified executive officers are appointed. Accordingly, Form 8-K would be revised to locate all executive compensation items in one location.

In addition, Item 5.02 would be expanded to incorporate narrative disclosure of any material new compensatory plan, contract, or arrangement to which the

named executive officer is a party or in which he or she participates as well as any material amendments and grants or awards thereunder. Finally, Item 5.02 would supplement Item 402 by requiring disclosure of a named executive's salary and bonus if such amount was not calculable at the time the prior Item 402 disclosure was made.

Additional Items

In addition to the changes discussed above, the SEC is proposing that related-party payments, currently disclosed under Item 404, would be included in Item 402 if the primary purpose is to furnish compensation to a named executive officer. Also, the SEC believes that relocation plans should not be excluded from reporting under Item 402 because of their susceptibility to discriminatory operation in favor of executives. Accordingly, the value of relocation plan payments would be required to be disclosed as reportable compensation.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

Robert W. Ballenger
Philadelphia
+1 215 994 2208
robert.ballenger@dechert.com

Judith M. Bandler
New York
+1 212 698 3548
judith.bandler@dechert.com

Stanley D. Baum
New York
+1 212 891 9277
stanley.baum@dechert.com

Richard D. Belford
New York
+1 212 891 9449
richard.belford@dechert.com

Susan M. Camillo
Boston
+1 617 728 7125
susan.camillo@dechert.com

David F. Jones (Chair)
Philadelphia
+1 215 994 2822
david.jones@dechert.com

Paul S. Kimbol
Philadelphia
+1 215 994 2603
paul.kimbol@dechert.com

Ryan M. Metz
Philadelphia
+1 215 994 2821
ryan.metz@dechert.com

Melissa K. Ostrower
New York
+1 212 891 9578
melissa.ostrower@dechert.com

Abigail B. Pancoast
Philadelphia
+1 215 994 2574
abigail.pancoast@dechert.com

Drew A. Picciafoco
Boston
+1 617 728 7109
drew.picciafoco@dechert.com

Beth L. Rubin
Philadelphia
+1 215 994 2535
beth.rubin@dechert.com

Stephen W. Skonieczny
New York
+1 212 698 3524
stephen.skonieczny@dechert.com

Frank B. Tripodi
New York
+1 212 698 3871
frank.tripodi@dechert.com

Kathleen Ziga
Philadelphia
+1 215 994 2674
kathleen.ziga@dechert.com

U.S.

Austin
Boston
Charlotte
Harrisburg
Hartford
New York

Newport Beach
Palo Alto
Philadelphia
Princeton
San Francisco
Washington, D.C.

U.K./Europe

Brussels
Frankfurt
London
Luxembourg
Munich
Paris

© 2006 Dechert LLP. All rights reserved. Materials have been abridged from laws, court decisions, and administrative rulings and should not be considered as legal opinions on specific facts or as a substitute for legal counsel.