

Final SEC Rules on Executive Compensation Disclosures

On August 11, the Securities and Exchange Commission (the "SEC") issued final rules making extensive changes to the rules that govern public company disclosures of executive and director compensation.¹ The SEC issued proposed rules in January and voted to approve these final rules on July 26. As expected, the final rules make significant changes to the proposed rules on option grant and pension plan disclosures, and will be effective for the 2007 proxy season.

One of the major changes to the current executive compensation disclosure rules is a requirement that a single total compensation figure be provided for each covered executive each year. This annual figure will include the value of option and other equity grants made and certain retirement benefits earned during a year. In addition, the rules will require dramatic changes to the disclosures on both retirement benefits and equity grants. We highlight below some of the key changes in the rules and attach copies of the new disclosure tables.

Overview

The final rules follow the approach of the proposed rules (as well as the current rules) with tables providing dollar amounts of particular compensation types and footnotes adding narrative explanations of the amounts shown on the chart. However, major changes are made to the current tables, including the elimination of certain tables. The rules also require that narrative explanations written in "plain English" provide any information necessary to understand the numbers in the tables.

Compensation Discussion and Analysis

In addition to the revised compensation tables, a new "Compensation Discussion and Analysis" section ("CD&A") is required. This new section will discuss material factors underlying policies and decisions reflected in the compensation amounts disclosed in the tables. Items to be addressed in the CD&A may include the following:

- the impact of accounting and tax treatment of different compensation types, including the annual \$1 million limit on deductions under Code §162(m)
- decisions made to waive or modify performance goals
- option grant practices (as described below)

¹ SEC Release 33-8732. The Release also limits to some extent the benefits-related information required to be filed on a Form 8-K and provides new rules in the following areas that we do not address: related party transactions, director independence and other corporate governance matters.

The CD&A will be filed by the company as part of the proxy and will serve the function of the currently required compensation committee report. However, the compensation committee will also need to furnish a brief report indicating that it has reviewed the CD&A with management.

Expanded Summary Compensation Table

As noted above, the final rules require that a total compensation figure be included in the Summary Compensation Table (the "SCT") for each covered executive for each of the last three completed fiscal years. This bottom line dollar figure is the sum of the amounts in all the other columns (e.g., salary, bonus). Other changes of interest to the SCT include:

- The annual change in actuarial value of defined benefit plans² (including both tax-qualified and supplemental plans) and above-market earnings on nonqualified deferred compensation will be presented in a separate column.
- The dollar value of equity awards granted during a year will be presented in a column and based on the grant date full fair value as determined under FAS 123R.
- For non-equity incentive awards, only amounts that have actually been earned are disclosed (i.e., new grants are not).
- Any deferral of compensation, both elective and non-elective, must be included in the appropriate column.
- Any compensation that is not reported in the other columns of the SCT must be disclosed under the "All Other Compensation" column, with footnote disclosure of items in excess of \$10,000 (see below for treatment of perquisites). Examples of amounts that would be included in this catch-all column include the following:
 - amounts paid or accrued in connection with any termination of employment or change in control
 - employer contributions or other allocations to defined contribution plans
 - all premiums paid on life insurance for an executive
 - "gross-ups" or other amounts reimbursed for the payment of taxes
 - company securities purchased at a discount from market price

² To calculate this amount, a company must use the same assumptions it applies pursuant to FAS 87.

Grants of Plan-Based Awards Table

This table supplements the disclosure in the SCT by providing additional information with respect to performance and non-performance based grants under both equity and non-equity incentive plans. Generally, the additional information includes the grant-by-grant disclosure of the number of shares of stock underlying each award, grant date, exercise price, and the estimated future payouts. The table is discussed in more detail below.

Narrative Description to SCT and Grants of Plan-Based Awards Table

Generally, a company will be required to provide a narrative description of any additional material factors necessary to provide an understanding of the tabular disclosure. The final rules outline some narrative disclosures which may be necessary for the SCT and the Grants of Plan-Based Awards Table, including:

- description of an executive's employment agreement
- material terms of any equity awards (e.g., vesting, whether dividends will be paid)
- any re-pricing or other material modification of an option or SAR (such as change in vesting or extension of the expiration date)
- description of the conditions for performance-based awards
- explanation of the amount of salary and bonus in proportion to the total compensation

Retirement Benefits Disclosures

The final rules significantly expand the requirements for retirement benefits disclosure. Under the current rules, a separate Pension Plan Table provides limited information on potential benefit amounts under a company's defined benefit plans. As noted above, the value of annual actuarial increases in defined benefits will now need to be included in the SCT. In addition, the final rules will require two tables with more details on retirement benefits, summarized below.

Pension Benefits Table

A new "Pension Benefits Table" will disclose the actuarial present value of a covered executive's accumulated benefit under each defined benefit plan (i.e., lump-sum value).³ This disclosure applies without regard to the particular form(s) of benefit payment available under the plan. The following information must be provided in the table for each qualified or non-qualified defined benefit plan in which an executive participates:

- plan name

³ This amount is computed as of the pension plan measurement date for financial statement reporting purposes with respect to the audited financial statements for the company's last completed fiscal year.

- executive's years of credited service
- actuarial present value of the accumulated benefit
- any pension payments made to the executive during the last completed fiscal year

Companies will have to use their FAS 87 assumptions to derive the present value of the accumulated benefit,⁴ except that retirement age shall be assumed to be the normal retirement age as defined in the plan (or if not defined, the earliest time at which a participant may retire under the plan without any benefit reduction due to age). These estimated benefit amounts should be based on an executive's current compensation. Additionally, the final rules require footnote disclosure of any credited years of service beyond actual years of service and any resulting benefit increase.

A narrative description of each plan's provisions would follow the table if needed for an understanding of the amounts disclosed in the table. This narrative would address:

- material terms of each plan (e.g., benefit formula, eligibility standards, and early retirement arrangements)
- why, if there are multiple plans, such plans are maintained
- the compensation elements used in determining benefits
- policies regarding grants of additional years of service

Nonqualified Deferred Compensation Table

A new table will be required for nonqualified defined contribution plans (i.e., deferred compensation plans that are not tax-qualified). This table will show the following amounts for each plan for the most recent year:

- executive contributions
- employer contributions
- total interest and other earnings (not just the above-market earnings reported in the SCT)
- withdrawals and distributions
- ending balance

⁴ The company must disclose in the narrative the valuation method and all material assumptions applied in quantifying the present value of the current accrued benefit. Companies may satisfy this requirement in whole or in part by reference to a discussion of those assumptions in the company's financial statements, footnotes to the financial statements, or discussion in the Management's Discussion and Analysis.

Unlike the current rules which require disclosure of only above-market earnings, the final rules require disclosure of all earnings in the Nonqualified Deferred Compensation Table. Additionally, the final rules require a footnote indicating the extent to which the contributions and earnings are (or were previously) reported in the SCT. As with the Pension Benefits Table, a narrative should accompany the table in order to provide a better understanding of the numbers in the table. This narrative could address the types of compensation permitted to be deferred, measures for calculating earnings, and distribution rules.

Stock Option Grant Disclosures

As expected, the final rules mandate more detailed disclosures related to stock option grant practices. The SEC makes clear in the final rules that it does not seek to encourage or discourage the use of stock options (or any other particular form of compensation), but that full and fair disclosure is required. It is worth noting that the rules do not use the terms "backdating" or "spring loading," when addressing the new option timing disclosures. The rules do permit the grant of options with exercise prices below fair market value so long as the company makes full and fair disclosures of such grants in compliance with the rules.

The rules require disclosure related to two primary areas of concern involved with option grants: (1) timing, and (2) the determination of exercise prices. The rules require that these two issues be addressed in both tabular and narrative disclosures.

Tabular Disclosures

The rules require the following tabular disclosures related to a company's option grants:

- Option grants must be disclosed in the SCT at their fair market value on the grant date, as determined by FAS 123R.
- The "grant date" of each option, as determined under FAS 123R must be disclosed on the Grants of Plan-Based Awards Table.
- If an option is "in the money" when granted (i.e., its exercise price is less than the **closing** market price of the underlying security on the grant date), a separate and adjoining column showing that closing market price must be added to the Grants of Plan-Based Awards Table, and a description of the methodology for determining such exercise price must be included in either a footnote or in a narrative disclosure.
- If the grant date is different from the date the compensation committee or full board of directors takes action or is deemed to take action to grant an option, a separate and adjoining column showing the date of such action (or deemed action) must be added to the Grants of Plan-Based Awards Table.

Narrative Disclosures

In order to provide context to the tabular disclosures with respect to option grants, the rules require companies to address, in narrative form, matters related to option compensation in

the CD&A section, particularly as they relate to the timing and pricing of option grants. Several examples provided in the rules illustrate how timing and pricing issues might need to be covered in a company's disclosures.

A primary concern for the SEC as to timing involves the delayed or accelerated grant of options in connection with the release of material non-public information. If a company engages in such a practice, the CD&A section should address issues such as:

- whether the company has a practice to time option grants to its executives in coordination with the release of material non-public information
- how such practice fits in the context of a company's practice (if any) with regard to option grants to employees more generally
- the role of the compensation committee in approving and administering the practice
- the role of the executive officers in the practice
- whether the company plans to time, or has timed, its release of material non-public information for the purpose of affecting the value of executive compensation

Generally, options are granted with an exercise price equal to the fair market value of a company's shares on the grant date. Some companies may have a practice of awarding options and setting the exercise price based on the underlying stock's price on a date other than the actual grant date. The rules mandates that such a practice requires disclosure, as appropriate, in the same tables described above with respect to "timing," and in narrative form in the CD&A section, as appropriate.

In addition, a company may have provisions in its option plan or have followed practices for determining the exercise price 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. Since these provisions increase the likelihood that recipients will be granted options that are "in the money," and since these provisions are, in the SEC's opinion, related to a material term of an option grant, these provisions should be disclosed in the CD&A section.

Other Equity and Incentive Award Disclosures

In addition to the above-described changes to option grant disclosures, the current tables for equity compensation and incentive awards have been dramatically re-worked. Unlike the old tables which focused primarily on stock options and SARs, the new tables require similar disclosures for all equity awards, including restricted stock and restricted stock units. In addition, the separate Long-Term Incentive Plan Award Table has been eliminated, and disclosures regarding those types of awards (e.g., cash bonus based on three-year performance cycle) are now provided in the same table along with equity awards. We summarize below the new tables.

Grants of Plan-Based Awards Table

A new table will be required disclosing performance-based awards made to covered executives during the last year. This covers equity awards (including restricted stock, restricted stock units, options, and SARs) as well as non-equity awards, such as a cash bonus based on a three-year performance period. Disclosure must be provided of the grant dates, exercise prices (for options and SARs), and the expected future payout amounts under three assumptions: threshold, target, and maximum.

This same table also must contain a summary of the key terms of other, non-performance based equity awards made during the last year. Disclosure of non-performance based equity awards was originally proposed to be included in a separate table, but was consolidated with this table in the final rules.

Awards shown on this table must be disclosed on an individual grant-by-grant (rather than aggregate) basis. Dropped from the proposed version of this table are columns reflecting a vesting date, or performance or other period until vesting or payout, expiration date, and consideration paid for an award.

Outstanding Equity Awards at Fiscal Year-End Table

A second table will disclose information regarding outstanding equity awards, such as stock options, SARs, restricted stock and restricted stock units. This table has been revised from its proposed form to more clearly delineate between information regarding option awards and the information regarding stock awards. Columns in this table that apply to unexercised options, SARs and similar instruments now require the disclosure of the number of securities underlying unexercised awards that are exercisable, the number of securities underlying unexercised awards that are unexercisable, the exercise or base price, and the expiration date of the award. As with the Grants of Plan-Based Awards Table, disclosure of individual (rather than aggregate) exercise prices and expiration dates is required in this table. The table will also disclose the market-based values of stock awards as of the company's most recent fiscal year end.

Option Exercises and Stock Vested Table

A third table will show the number of shares acquired by a covered executive on the exercise of an option or SAR or the vesting of restricted stock or restricted stock units during the most recent year, as well as the value realized by the officer on exercise or vesting. The final rules eliminated a column that was proposed earlier, which would have showed the grant date fair value of each option or stock award. The column was eliminated because of concerns about double counting of amounts previously disclosed in the SCT and confusion that such disclosure might cause.

Equity Award Disclosures Eliminated

Because the rules require disclosure of the grant date fair value of options and SARs in the SCT, the current disclosure in the Options/SAR Grants Table on the potential realizable value of such awards is eliminated. Similarly, the Ten-Year Option/SAR Repricings chart in the current rules is eliminated.

Rules for "Perks"

As noted above, perquisites and other personal benefits ("perks") provided to covered executives must be included in the SCT, subject to the following revised rules:

- Narrative disclosures on perks are required unless the total value of the perks is less than \$10,000. Disclosure is required under the current rules only if the value exceeds the lesser of \$50,000 or 10% of the total annual salary and bonus.
- Unless the de minimis exception above applies, each perk must be identified in a footnote. If a perk is valued at \$25,000 or more (or 10% of the total perks, if greater), then its "value" must also be disclosed.
- Perk values are still determined based on the aggregate incremental cost to the employer, rather than fair market value or other IRS standards (e.g., SIFL rates for airline travel). Footnote disclosure is required on the methodology used to compute such costs.

The SEC declines to define the term "perk," but the rules do provide important guidelines on identifying perks, as well as a number of specific examples. Items that are integrally and directly related to job performance are not perks. Items that confer a direct or indirect benefit that has a personal aspect, unless available on a non-discriminatory basis to all employees, are considered perks. Finally, the SEC notes that it is not relevant to the determination that an item is deductible as an ordinary and necessary business expense, or is provided for some business reason or for the convenience of the company.

Severance and Change in Control Payments

As under the current rules, a narrative description of the material terms of any arrangement providing for payments upon severance or change of control will be required. In addition, estimated payment (and benefit) amounts and payment methods (e.g., lump sum) must be provided for different payment triggers under such arrangements. The estimated amounts are to be calculated assuming that the triggering event (e.g., termination of employment) occurred on the last day of the company's last completed fiscal year and using the company's stock price on that date.

Covered Executives

The new disclosure requirements will apply to a company's principal executive officer, principal financial officer, and the three other most highly compensated executive officers serving at the end of the last completed fiscal year. The determination of the most highly paid officers will be based on total compensation as would be shown in the SCT less the amount that would be shown in the "retirement benefits" column of the SCT.

The final rules do not include the proposed narrative disclosures for up to three non-executive employees if their total compensation for the most recent year was greater than that of any of the covered executives. However, the SEC has asked for further comments on this issue.

Director Compensation

Because director compensation packages have become more complex, the rules require disclosure of all director compensation for the most recent year in a table resembling the SCT (including a column for retirement benefits). Although the rules do not require tabular disclosure of director's outstanding equity awards, these awards would be disclosed in a footnote.

Effective Date

The rules will apply for proxies and Forms 10-K for fiscal years ending on or after December 15, 2006. Thus, the rules will apply to proxies issued in 2007 which provide disclosures on 2006 compensation amounts. The SEC makes clear that the new rules will not have to be applied to the compensation disclosures for prior years in 2007 proxies (i.e., disclosures for 2005 and 2004 need only comply with current rules).

Tax Implications

The IRS is now actively auditing executive compensation arrangements at large companies, and agents are instructed to review annual proxies and other SEC filings to gather information on the arrangements. Thus, these new rules will provide additional information for the IRS as they look for problems under relevant Code provisions (e.g., sections 162(m) and 409A).

Employers will also soon be reporting annual amounts accrued under nonqualified defined benefit plans subject to Code section 409A on executives' Forms W-2. While the IRS has not yet provided guidance on how these amounts are to be calculated, their requirements may not line up with the SEC's requirements for calculating such amounts (i.e., use of FAS 87 assumptions). Coordination on this issue between those preparing the annual accrual numbers for the proxy and those preparing similar numbers for the Forms W-2 seems advisable.

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Please call one of the following, or the firm attorney you regularly contact, if you have any questions about the new SEC rules.

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