



ZAG/S&W LLP Client Advisory

Changes To Real-Time Disclosure of Executive Compensation

SEC Revises 8-K Reporting Rules

In the past few years, public companies have struggled to determine what types of executive and director compensation need to be reported and when. As part of its sweeping overhaul of executive compensation disclosure, the Securities and Exchange Commission, or SEC, has adopted changes to disclosures required on Current Reports on Form 8-K in an effort to give companies some clearer guidance.

The 8-K reporting requirements have changed in a few key ways: (1) executive compensation disclosure has been moved to the 8-K item dealing with the appointment and departure of executives and directors; (2) the list of persons whose compensation arrangements must be disclosed has changed; and (3) the events triggering an 8-K filing have changed.

The new rules are effective for 8-K triggering events that occur on or after November 7, 2006.

Whose Compensation Arrangements Must Now Be Reported?

The new executive compensation rules provide a new formula for determining the "named executive officers" (NEOs) whose compensation arrangements must be disclosed. NEOs will now be defined to include (1) any person who served during the year as the principal executive officer, or PEO (whether or not still in office); (2) any person who served during the year as the principal financial officer, or PFO (whether or not still in office); (3) the three other most highly compensated executive officers who were serving as executive officers at the end of the fiscal year; and (4) up to two additional persons who served as executive officers during, but not at the end of, the fiscal year, whose total compensation is higher than that of any of the three other most highly compensated executive officers described above. The minimum threshold for disclosure of compensation will be \$100,000 of total compensation, except for the PEO and the PFO, whose compensation must be disclosed regardless of amount.

In determining the most highly compensated executives, the computation of the compensation will now be based on "total compensation" which includes salary, bonus, stock awards, option awards, non-equity incentive plan compensation, and other forms of compensation such as perquisites. These components are reported in the "Summary Compensation Table" in proxy statements.

To avoid confusion, NEO status is determined by reference to the last required disclosures regarding executive compensation (typically in the company's last proxy statement). The persons identified as the NEOs who are not otherwise the principal executive or financial officer will not change during the year even if their compensation or titles change or if other executives are appointed.

Most of the compensation disclosures on 8-Ks will be required only of the NEOs. However, as described further below, under the new rules, certain compensation arrangements must also be reported for directors and the president, principal accounting officer and principal operating officer (these officers, together with the NEOs, are referred to as the “covered officers”) when in connection with that person’s appointment or election.

How Have the Rules Been Clarified?

Under the existing rules, companies must report executive compensation in connection with the requirement to report an “entry into a material definitive agreement.” For executive officers and directors, the current rules refer to the SEC’s material contract exhibit rules, which provide that any management contract or compensatory plan, contract or arrangement for a NEO or director is material. For executive officers who are not NEOs, the exhibit rules provide an exception if the arrangement is immaterial in amount or significance, a basket within which many non-NEO arrangements fall. The lack of a materiality qualifier for NEOs and directors, however, has led to what most practitioners and the SEC believe is over-reporting of arrangements and has resulted in immaterial compensation actions masking those that are truly “unquestionably or presumptively” material.

The new rules shift disclosure of executive and director compensation from Item 1.01 (and 1.02) to Item 5.02 of 8-K, which covers departure and appointment of officers and directors. In doing so, the SEC has decoupled the exhibit rules with these reporting requirements and more clearly identified which events trigger compensation disclosures. The new rules have expanded the scope of Item 5.02 to include disclosure requirements for material amendments to compensation arrangements and awards made to NEOs during their employment.

What Compensation Arrangements Must Now Be Reported?

The new rules limit the reporting of compensation arrangements to ones that (1) are in connection with the appointment or election of covered officers and directors; or (2) involve a NEO and are material. The company must include a brief description of the triggering event, but does not need to go into the same amount of detail as the executive compensation disclosure in a proxy statement.

In summary, the following is the new list of compensation events that trigger 8-K reporting:

- When a covered officer, including a NEO, is appointed or a director is elected (other than at a shareholder meeting) a brief description of (1) any material plan, contract or arrangement (whether or not written) to which such person is a party or in which he or she participates that is entered into or materially amended in connection with the triggering event; and (2) any grant or award to any such person or modification thereto under any such plan, contract or arrangement in connection with any such event;
- When a material compensatory plan, contract or arrangement (whether or not written), as to which a NEO, including the principal executive or financial officer, participates or is a party is entered into, adopted or otherwise commenced, or materially amended, or when a NEO receives a material grant or award (or material modification) under any such plan, contract or arrangement. Note that this trigger applies regardless of whether the event is in connection with the NEO’s appointment or not; and
- When a NEO’s salary or bonus is determined for the prior fiscal year if it was not calculable at the time of the company’s last proxy statement or Form 10-K. If this event is triggered, the 8-K must also disclose the new total compensation figure for the NEO as it would have appeared in the proxy statement.

For NEOs, outside of the appointment context, grants or awards or modifications thereto made pursuant to a plan, contract or arrangement that are materially consistent with the original terms of such plan, contract or arrangement do not need to be disclosed as long as the company has previously disclosed such original terms and the grant, award or modification is disclosed when executive compensation disclosure is next required (e.g., in the next proxy statement).

Though these rules lead to some notable changes (e.g., changes to director compensation no longer need to be reported on an 8-K), the SEC has not provided any further official guidance on what constitutes a "plan, contract or arrangement." Companies must therefore continue to use their best judgment on items such as at-will employment relationships, bonus plans and other situations that may be deemed to fall within the broad scope of these terms. However, the new rules allow for greater flexibility on reporting about NEOs by including the materiality qualifier.

Companies also need to keep in mind that although the 8-K triggers have changed, the exhibit rules have not. Changes to material contracts still need to be filed, as before, with the 10-Q or 10-K covering the period in which the change occurs. For example, although a change in director compensation will no longer trigger an 8-K, if a director compensation plan is on file as an exhibit, any change to that plan must be filed as an exhibit to the company's next 10-Q or 10-K, whichever comes first.

Safe Harbor Provision

In connection with the new 8-K rules, the existing safe harbor for failure to file certain 8-Ks was extended to cover a failure to disclose a new compensation arrangement or award to NEOs, other than in the context of their appointment. If reported in the next periodic report, no Section 10(b)/Rule 10b-5 liability will result and, regardless of when reported, there will be no adverse impact on a company's eligibility to use short-form registration statements on Form S-3 as long as the information is filed prior to the filing of the applicable Form S-3. This extended safe harbor still does not cover the reporting of plans and arrangements upon appointment; only new arrangements or material changes for NEOs at other times.

Recommendations

The above summary is intended to provide an overview of the new 8-K executive compensation reporting rules. Despite the clarifications made by the SEC, many tricky areas still remain. We encourage companies to analyze each and every aspect of an executive officer's or director's compensation and any change made thereto as it occurs in order to quickly determine if any 8-K reporting is required. In addition, companies should carefully review their disclosure controls and procedures to make sure they are designed to identify the covered plans, contracts and arrangements in order to allow for timely 8-K reporting. To discuss the 8-K or executive compensation rules in more detail, please contact your lawyer at ZAG/S&W LLP or one of the lawyers listed below.

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