



SEC Adopts Sweeping Reforms to Executive Compensation Disclosure

How much is paid not directly regulated, but companies to provide more robust description of what they pay and why

In response to an increasing outcry over exorbitant pay and severance packages for public company executives, the Securities and Exchange Commission, or SEC, has overhauled its requirements for what public companies must disclose each year in their proxy statements relating to annual shareholder meetings. The new rules include increased tabular and narrative information and enhanced analysis of all of the components of executive and director compensation and how such amounts are determined by a company's compensation committee or otherwise. The new rules also update the disclosure requirements with respect to transactions between companies and insiders, commonly referred to as "related person transactions." The SEC believes that by requiring companies to provide "plain English," yet detailed (and sometimes lengthy), descriptions of executive and director compensation and related person transactions, investors will be able to make better informed decisions regarding the companies in which they invest.

Compensation Discussion and Analysis

Under the new rules, a new "Compensation Discussion and Analysis," or CD&A, will replace the current compensation committee report.¹ The CD&A can be viewed as the equivalent of the "Management's Discussion & Analysis" for executive compensation, with an emphasis on *analysis*. CD&A should not focus on the compensation committee's process, which will now be described in a separate part of the proxy statement; rather, it should analyze all elements of compensation. The CD&A will provide a more structured narrative discussion about the material factors underlying compensation of the company's named executive officers, or NEOs.

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 compensation for these purposes, total compensation is used rather than consideration of only salary plus bonus.

¹ Small Business Issuers will not be required to provide the new CD&A or compensation committee report. In addition, the definition of NEO and the compensation tables and related person disclosure required differ for Small Business Issuers as compared to other issuers. For questions about how the new rules impact Small Business Issuers, please contact us.

Total compensation for NEO-determination purposes does not include any increase in pension values, any above-market or preferential earnings on nonqualified deferred compensation or any compensation for overseas assignments attributable predominately to such assignments.

The company will be required to explain *all* material elements of compensation of *each* NEO, including: (1) the objectives of the company's compensation programs; (2) what the compensation programs are designed to reward; (3) each element of compensation; (4) why the company chooses to pay each identified element of compensation; (5) how the company determines the amount of each element and (6) how such elements and the company's decisions regarding each element fit into the company's overall objectives and affect decisions regarding other elements.

Note, however, that as under current rules, companies will not be required to disclose non-public, competitively-sensitive target levels with respect to performance-related factors or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm to the company. However, if this information is not disclosed, the company must discuss how difficult it will be for the executives or how likely it will be for the company to achieve the undisclosed target or other factors.

The goals of the CD&A section go well beyond those of the existing compensation committee report. The CD&A is intended to be an overview that puts into context the compensation disclosure provided in the subsequent tables and narrative. The rules are "principles-based;" that is, they identify disclosure concepts and provide a list of illustrative examples. Accordingly, the CD&A must avoid the use of "boilerplate" language (i.e., vague explanations subject to different interpretations).

To aid in drafting the CD&A, the SEC has provided examples of topics that may be considered material for purposes of disclosure, such as:

- Any policy for allocating between long-term and currently paid out compensation;
- Policies for allocating between cash and non-cash compensation and among different forms of non-cash compensation;
- For long-term compensation, the basis for allocating compensation to each different form of award;
- How the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
- What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- How specific elements of compensation are structured and implemented to reflect these items of the company's performance and the executive's individual performance;
- The factors considered in decisions to increase or decrease compensation materially;
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits);
- The impact of accounting and tax treatments of a particular form of compensation including Internal Revenue Code Section 162(m) which limits deductibility of compensation that does not meet specified requirements to be performance-based;

- The company's equity or other security ownership requirements or guidelines and any company policies regarding hedging the economic risk of such ownership;
- Whether the company engaged in any benchmarking of total compensation or any material element of compensation identifying the benchmark and, if applicable, its components (including component companies);
- The role of executive officers in the compensation process;
- Company policies and decisions regarding the adjustment or recovery of awards or payments if the relevant company performance measures are restated or otherwise adjusted in a manner that would reduce the size of an award or payment; and
- The basis for selecting particular events as triggering payment with respect to post-termination agreements (e.g., the rationale for providing a single trigger for payment in the event of a change-in-control).

The list of examples provided by the SEC is not meant to be exhaustive and, while company disclosure may not encompass all of the above examples, it is imperative that the company include any individualized disclosure that is similar in nature to the examples noted above.

The CD&A will be filed with, rather than furnished to, the SEC, and therefore, will be subject to disclosure liability and included in the material incorporated in a company's annual report on Form 10-K that is certified by the company's PEO and PFO. In order for PEOs and PFOs to comfortably sign off on 10-Ks, they will likely want to review a draft of the CD&A, thus accelerating the proxy statement drafting schedule.

In lieu of the current compensation committee report, companies will be required to furnish a signed compensation committee report with the CD&A that must state: (1) whether the committee has reviewed and discussed the CD&A with management; and (2) whether, based on the review, the committee recommended to the board of directors that the CD&A be included in the company's 10-K and proxy statement. The new form of report is a way to keep the compensation committee invested in and held responsible for the contents of the CD&A.

New and Revised Compensation Tables

While CD&A will provide increased analysis of executive and director compensation, the Summary Compensation Table and other tables, together with the accompanying supplemental narrative disclosures, remain the principal vehicle for disclosure of the data underlying that analysis. The new rules change those tables in significant ways and require companies to carefully review every aspect of compensation to determine in which table(s) information needs to be disclosed.

Under the new rules there are six tables, which will provide comprehensive disclosure of all compensation to NEOs. The tables disclose compensation in three major areas (1) compensation paid or deferred during the past three fiscal years; (2) holdings of outstanding equity-related interests that may be the source of future gains and (3) post-employment payments and benefits.

Summary Compensation Table. The Summary Compensation Table reports the dollar value of seven categories of compensation paid to, or earned by, NEOs during the last three completed fiscal years (subject to a transition period as described below), together with a Total column that sums all types of compensation in one single dollar amount.

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (4)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
[NAME]									

Stock Awards and Option Awards. The Summary Compensation Table continues to include two columns relating to equity-based compensation during each fiscal year. These columns have been renamed Stock Awards and Option Awards. Unlike the current rules, however, the new rules require all such awards to be shown based on their fair market value on the date of grant in accordance with FAS 123(R).

Non-Equity Incentive Plan Compensation. The Non-Equity Incentive Plan Compensation column must include the dollar value of all earnings for services performed during the fiscal year pursuant to awards under non-equity incentive plans. Incentive plans are those intending to provide incentive for performance to occur over a specified period, whether measured by reference to financial performance, stock price or other performance measures. Non-equity incentive plans are incentive plans under which awards are granted that do not fall within the scope of FAS 123(R). Note that many awards previously characterized as “bonuses” will now show up as non-equity incentive plan compensation (and trigger disclosure on an additional new table). An award is deemed to be earned in the fiscal year in which the executive satisfies the performance criteria. Amounts earned during a fiscal year are reportable in that year, even if not payable until a later date, and are not reportable again in the year paid.

Change in Actuarial Value of Pension Benefits and Deferred Compensation. This new column requires disclosure of (1) the annual change in actuarial present value of accumulated pension benefits and (2) above-market or preferential earning on nonqualified deferred compensation. Negative changes in pension benefits will appear in a footnote, but not in the table.

All Other Compensation (Includes Perquisites). The reformatted Summary Compensation Table dispenses with two columns (Other Annual Compensation and All Other Compensation) and replaces them with a single column to capture all compensation not covered by other columns in the table. This column includes items such as perquisites, 401(k) plan matches, life insurance premiums and tax gross-ups. Under the new rules, perquisites and other personal benefits will be disclosable if their total value is \$10,000 or more. All perquisites having a value of \$10,000 or more must be identified in a footnote. Further, any perquisite that has a value exceeding the greater of \$25,000 or 10% of total perquisites and other personal benefits provided to the NEO must be both identified and quantified in a footnote. The SEC has stated that an item is not a perquisite if it is integrally and directly related to the performance of the NEO’s duties. An item is otherwise a perquisite if it confers a direct or indirect benefit that has a personal aspect, without regard

to whether it may be provided for some business reason or for the convenience of the company (unless it is generally available to everyone at the company).

Grants of Plan-Based Awards Table. The Grants of Plan-Based Awards Table supplements the Summary Compensation Table by providing additional information about stock options and other equity awards granted during the last fiscal year.

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards (\$/Sh)
		Threshold (\$)	Target (\$)	Maximum (\$)	Threshold (#)	Target (#)	Maximum (#)			
[NAME]										

This new table also must highlight any option grant 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 or narrative disclosure the methodology used to determine exercise price. The table also must 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.

The table must include all incentive plan awards that were made during the most recent fiscal year, whether or not equity-based. Estimated future payouts under non-equity incentive plans may cover periods beyond the amounts earned in the prior year that are included in the Summary Compensation Table. In this table, “threshold” refers to the amount payable for a certain level of performance under the plan and “target” refers to the amount payable if the specified performance target(s) are reached. “Maximum” is the maximum payment possible under the plan.

Narrative Disclosure. The new rules require a narrative description of any material factors necessary to understand the information disclosed in the Summary Compensation Table and the Grant of Plan-Based Awards Table. It is important to note that this is different from the CD&A disclosure in that CD&A focuses on the principles underlying executive compensation policies, generally. The narrative disclosure focuses on material factors that affected the actual compensation awarded to the NEOs in the relevant fiscal year. As with the CD&A, certain competitive, confidential information may be omitted.

Outstanding Equity Awards at Fiscal Year End Table. This table presents information on each outstanding award held by NEOs at the end of the last fiscal year.

	Option Awards					Stock Awards			
Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#)	Option Exercise Price (\$)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (\$)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (\$)
[NAME]									

Information on holdings will be presented on individual grant basis and thus could be a quite lengthy list. Footnote disclosure is required for recording of vesting dates for each award in the table.

Option Exercises and Stock Vested Table. This table shows amounts realized by NEOs resulting from equity-based compensation during the last fiscal year in connection with the exercise of options and the vesting of stock awards.

	Option Awards		Stock Awards	
Name	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise (\$)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting (\$)
[NAME]				

The disclosure of FAS 123(R) grant date value of awards is not required. Footnote disclosure is required to describe any amount deferred upon exercise of an option or vesting of a stock award.

Pension Benefits Table. The new Pension Benefits Table will replace the current Pension Plan Table and has been substantially revised to require detail of the actuarial present value of defined benefits under each pension plan in which a NEO is enrolled as well as pension benefits paid to each NEO during the last fiscal year.

Name	Plan Name	Number of Years Credited Service (#)	Present Value of Accumulated Benefit (\$)	Payments During Last Fiscal Year (\$)
[NAME]				

Each plan in which a NEO is enrolled will be shown in a separate row of the table. Estimates of the accrued benefits will be calculated under the assumption that the executive will retire in the first year allowed by the plan whereby benefits become payable without reduction. The calculations will use the NEO's current compensation and the same plan measurement date used for financial statement reporting purposes. The tables must be supplemented with a narrative description of material factors necessary to gain an understanding of each plan disclosed, including the plan's normal retirement payment, benefit formula and eligibility standards.

Non-Qualified Deferred Compensation Table. This new table discloses annual contributions by the NEO and the company under non-qualified defined contribution and other deferred compensation plans, including aggregate earnings, withdrawals or distributions, and balances at year end.

Name	Executive Contributions in Last FY (\$)	Registrant Contributions in Last FY (\$)	Aggregate Earnings in Last FY (\$)	Aggregate Withdrawals/ Distributions (\$)	Aggregate Balance at Last FYE (\$)
[NAME]					

The table must include footnote quantification of the extent to which amounts reported as contributions are also included in the amounts included as compensation in the Summary Compensation Table as well as the extent to which amounts shown in the "aggregate balance at last fiscal year-end" column were reported as compensation to the NEOs in the Summary Compensation Table for prior years. As with the pension table, narrative disclosure of any material factors necessary to understand each plan disclosed in the table must follow.

Potential Payments Upon Termination or Change of Control. The new rules require a description of each written or oral contract, agreement, plan or arrangement that provides for payments to a NEO at, following, or in connection with any termination, including resignation, severance, retirement or constructive termination, or a change of control of the company or a change in the NEO's responsibilities. This requires companies to carefully review all existing employment arrangements, benefit plans and incentive plans to see what payments are implicated by these events. All benefits triggered, including perquisites and health care, must be described and, though no table is required, estimated payments and benefits must be quantified, including hard-to-calculate items such as tax gross-ups for "golden parachute" payments. The description must explain how the appropriate payment and benefit levels are determined. In addition, any material conditions or obligations to the receipt of payments or benefits must be described, such as non-compete, non-solicitation or confidentiality agreements.

Director Compensation Table. The rules will require the reporting in tabular format of director compensation for the last fiscal year. The components of this table are substantially similar to those of the Summary Compensation Table.

Name	Fees Earned or Paid in Cash (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Change in Pension Value and Nonqualified Deferred Compensation Earnings	All Other Compensation (\$)	Total (\$)
[NAME]							

Disclosure for each director should be provided on a separate line except, to the extent that directors have identical compensation elements, they may be grouped in a single line. In this table, the company must include consulting fees, resignation or retirement payments, payments and “promises of payments” under director legacy or charitable award programs and other delineated items. Any compensation paid to a NEO for services provided as a director which is included in the Summary Compensation Table and appropriately footnoted need not be disclosed in the director compensation table. Footnote disclosure must cover aggregate outstanding equity awards held by directors as of fiscal year end. Narrative disclosure should describe compensation arrangements, such as fees, and any other material factors necessary to the understanding of the table.

Focus on Option Granting Practices. As part of the new rules, the SEC also adopted various changes to disclosure requirements focusing on the timing of option grants in relation to the release of material non-public information and the determination of exercise prices that differ from the closing price on the date of grant. In addition to the tables, narrative disclosure will appear in the CD&A, which should include all material information relating to option grants that appear in the Grants of Plan Based Awards table. The disclosure should address such issues as:

- Methodology used to select terms of awards and grant dates;
- Any program, plan or practice used by the company to determine the exercise price of an option where the price is not the closing market price on the date of grant;
- Any program, plan or practice used by the company to time option grants to executive officers with the release of material non-public information;
- How any such program, plan or practice fits into the context of grants to employees generally;
- The role of the compensation committee in approving or administering such program, plan or practice;
- Delegation of the administration of a program, plan or practice; and
- The role of executive officers in timing of option grants.

Changes to Disclosures About Related Person Transactions

The new rules also update disclosure requirements for related person transactions to make them more “principles based,” thus leaving more discretion to companies about disclosure of material information rather than providing many bright-line tests. Specific changes include:

- *Transactions with Related Persons*. The threshold for disclosing a related person transaction was increased to \$120,000 from \$60,000. The scope of transactions that must be disclosed has been expanded to include any transaction to which the company is a “participant” rather than a “party,” and to add broad definitions of the terms “transaction,” and “related person.”
- *Procedures for Approval of Related Person Transactions*. The rules add a requirement to describe the policies and procedures established by the company and its board of directors for reviewing, approving or ratifying related person transactions. In addition, related person transactions for which the company’s policies and procedures did not provide for review, approval or ratification or transactions where those policies were not followed need to be identified.

Changes to Disclosures About Corporate Governance

The disclosure requirements regarding director independence and corporate governance issues have been consolidated, and have been expanded to include the following:

- *Relationships with Independent Directors*. Companies must describe, by specific category or type, any transactions, relationships or arrangements not otherwise described in the related person transactions section that were considered by the board of directors in determining whether applicable independence standards were met with respect to each independent director or nominee. If a company uses its own definitions of independence, it must disclose whether such definitions are available on its website.
- *Compensation Consultants*. Any compensation consultants must be identified, and disclosure will be required as to whether such consultants are engaged directly by the compensation committee or by any other person, the nature and scope of their assignment, the main instructions provided to them and the consultant’s role in determining or recommending the amount or form of director and executive compensation.
- *Compensation Committee Charter and Functions*. New disclosures are required with respect to the compensation committee, which are similar to existing disclosure requirements for the audit and nominating committees. Pursuant to the new requirements, the company must disclose whether the compensation committee has a charter, and if so, must make the charter available through its web site or proxy materials. In addition, companies need to describe, separately from the CD&A, their processes and procedures for considering and determining executive officer and director compensation, including any role of officers or consultants.

Changes to Reporting of Executive Compensation on Form 8-K

The SEC has also attempted to clarify the 8-K reporting requirements for executive and director compensation arrangements and changes. The revised reporting requirements move these disclosures to a different 8-K item and more narrowly define for whom and when the information is required to be reported. These changes should result in fewer instances of reporting executive and director compensation, though the revised rules do not fully prescribe what events trigger an 8-K and, therefore, leave room for interpretation.

Other Changes

The rules make a few other miscellaneous changes, including:

- *Performance Graph*. The chart showing the performance of a company's stock previously included in the annual proxy statement will now instead be required to appear in the annual report to shareholders (but not the Form 10-K) mailed with the proxy statement.
- *Changes Related to Beneficial Ownership Disclosure*. Companies will now need to disclose the number of shares pledged as security by named executive officers, directors and nominees. In addition, the companies will be required to disclose beneficial ownership of directors' qualifying shares.
- *Audit Committee Charter*. If available on a company's website, a company no longer needs to include this as an appendix to its proxy statement every three years.

Effective Dates and Transition

The new rules regarding executive and director compensation are effective for proxy statements and registration statements filed after December 15, 2006 that are required to include the relevant information for fiscal years ending after such date. For example, for a company that operates under a calendar fiscal year end, the proxy statement for the 2007 annual meeting of shareholders will need to contain all of the enhanced executive and director compensation and related person transaction disclosures for the year ending December 31, 2006. With respect to the revised Summary Compensation Table, for the first year of compliance, a company need only provide the most recent year's information; this will increase to two years in the next proxy statement until fully phased in for the third successive proxy statement. Where the new disclosure is required, the executive compensation information for years prior to the transition period need not be restated or even presented at all. For example, for a calendar year end fiscal year end company, the proxy statement for the 2007 annual meeting will contain full updated disclosures for the year ending December 31, 2006, but will not contain either the old or new executive compensation tables for prior years.

Conclusion

One thing is clear from the new rules – more time will be needed to prepare for the upcoming proxy statement. To start, companies need to inventory all of their compensation arrangements, plans and programs that impact officers and directors, whether providing for payments or awards currently or in the future. Devices such as "tally sheets" that list every element of compensation will be vital in the preparation of both CD&A and the tabular disclosure. Disclosure controls and procedures, as well as director and officer questionnaires, will need to be adjusted to take into account all of the new disclosures and any potential issues need to be identified sooner rather than later. In addition, companies will need to review related documents such as compensation committee charters and corporate governance guidelines to make sure they adequately cover any responsibilities arising under the new rules. Companies may also want to adopt new or revise policies regarding the matters covered by the new rules such as related person transaction approvals, option granting practices, independent director criteria and others that will now be revealed to the public in plain English.

The summary above is meant to describe the major changes required under the SEC's new executive and director compensation and related person transaction disclosure rules and related matters. To discuss these topics in more detail, please contact your lawyer at ZAG/S&W LLP or one of the lawyers listed below.

September 2006

IF YOU WOULD LIKE ADDITIONAL INFORMATION, PLEASE CONTACT:

Howard E. Berkenblit
617 338 2979
hberkenblit@zag-sw.com

Shy S. Baranov
617 338 2932
sbaranov@zag-sw.com

Kathleen M. Boland
617 338 2881
kboland@zag-sw.com

Katherine E. Potter
617 338 2923
kpotter@zag-sw.com

Amy E. Sheridan
617 338 2897
asheridan@zag-sw.com

Gretchen S. Silver
212 660 3029
gsilver@zag-sw.com