

SEC Overhauls Rules on Executive Compensation Disclosure

Hardly a day goes by without an incendiary story in the press depicting the perceived excesses of executive compensation or the purported well-upholstered lifestyles of a select group of corporate executives: enormous pay and perquisite packages, problematic option dating practices, compensation committees packed with directors who owe allegiance to CEOs, unrestrained personal use by executives of corporate aircraft, stunning severance packages for supposedly failed executives and reports of “corporate kleptocracy” and other allegations of nest-feathering by executives and directors. With this onslaught of media attention, coming amid the revelation that many of these pay packages were not fully disclosed in SEC reports, it comes as no surprise that the SEC should decide to overhaul its rules related to disclosure of executive and director compensation and related-person transactions. As described by SEC Chairman Christopher Cox, the revised regulations adopted by the SEC at the end of July (www.sec.gov/rules/final/2006/33-8732.pdf) do not seek to judge or limit the amount that companies and their compensation committees can pay to executives. Rather, they require that all compensation be fully disclosed in a manner that is both comprehensive and comprehensible, so that shareholders can better determine whether executives are, as one business journalist phrased it, “getting superstar pay for journeyman work.”

The new rules and amendments mandate both expanded narrative and tabular

disclosure of executive and director compensation, restructure the rules for disclosure of transactions with related persons and expand and consolidate disclosure regarding corporate governance. These changes will affect disclosure in proxy statements, annual reports and registration statements, as well as the current reporting of compensation arrangements. Special rules, not addressed in this *Alert*, apply to small business issuers and foreign private issuers.

Highlights

Highlights of the SEC’s 436-page release include:

- ▶ a new, plain English, principles-based narrative analysis, termed the “Compensation Discussion and Analysis” (CD&A), about executive compensation policies and practices;
- ▶ a new, abbreviated Compensation Committee Report, comparable in form and substance to the current Audit Committee Report, regarding the committee’s review and recommendation of the CD&A;
- ▶ a revised Summary Compensation Table (SCT) reporting compensation of the principal executive officer (PEO), principal financial officer (PFO) and the three other highest paid executive officers determined on the basis of total compensation, as adjusted, and now including columns showing the dollar value for all equity-based awards, as well as a separate column for “total compensation”;

- ▶ supplementary to the SCT, a Grants of Plan-Based Awards Table that will augment some of the compensation information presented in the SCT;
- ▶ two new tables reporting equity—the Outstanding Equity Awards at Fiscal-Year End Table, showing awards that

KEY ATTORNEY CONTACTS

Barbara Borden	858/550-6064 bordenbl@cooley.com
Darren DeStefano	703/456-8034 ddestefano@cooley.com
Brent Fassett	720/566-4025 fassettbd@cooley.com
Kenn Guernsey	415/693-2091 kguernsey@cooley.com
Jim Linfield	720/566-4010 linfieldjct@cooley.com
Susan Philpot	415/693-2078 philpotsc@cooley.com
Cydney Posner	415/693-2132 cposner@cooley.com
Tom Reicher	415/693-2381 treicher@cooley.com
Thomas Welk	858/550-6016 twelk@cooley.com
Francis Wheeler	720/566-4231 fwheeler@cooley.com
Nancy Wojtas	650/843-5819 nwojtas@cooley.com

This information is a general description of the law and is not intended to provide specific legal advice.

Copyright © 2006 Cooley Godward LLP, 3000 El Camino Real, Palo Alto, CA 94306. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward LLP as the author. All other rights reserved.

Contents

Highlights	1
What Companies Should Be Thinking About Now	2
Compliance Dates	3
Executive & Director Compensation	3
Compensation Discussion and Analysis	3
Summary Compensation Table	6
Option Grant Timing and Pricing Disclosure	12
Holdings and Exercises of Previously Awarded Equity	14
Post-Employment Compensation	15
Compensation of Directors	17
Related-Person Transactions	18
Other Changes	21
Corporate Governance	21
Form 8-K	23
Beneficial Ownership Disclosure	24
Conforming Amendments	24
Plain English Disclosure	25
Transition	25
Final Words	26
Appendices	27

represent potential future compensation, and the Option Exercises and Stock Vested Table, showing amounts realized on equity compensation during the last fiscal year—accompanied by explanatory narrative;

- ▶ new SEC guidance regarding disclosure of practices relating to the timing of option grants in coordination with the release of material nonpublic information and the selection of exercise prices that differ from the underlying stock's price on the grant date;
- ▶ new tabular and explanatory narrative disclosure regarding director compensation;
- ▶ new tabular disclosure regarding pension benefits and nonqualified deferred compensation, as well as expanded narrative description of termination and change-in-control arrangements;
- ▶ principles-based disclosure of related-person transactions, including substantial elimination of differences between disclosure regarding indebtedness and other transactions;
- ▶ expanded disclosure regarding director independence and compensation committees; and
- ▶ changes to Form 8-K regarding executive compensation matters.

What Companies Should Be Thinking About Now

The new rules will impose substantial changes on how public companies report about the compensation they pay to their executives and directors. Under the new rules, companies will need to convey their practices and processes, as well as the results of those practices and processes, in high definition. As the new director of the SEC's Division of Corporation Finance, John White, has urged, "companies may be well-served by preparing to tell their compensation stories tomorrow, and thus really learning the processes and procedures behind their compensation programs today. And by thinking about the story

they'd like to tell, some companies may, perhaps, even decide to reshape their processes now."

While, to a large extent, compensation reportable in next year's proxy statement under these new rules has already been determined, companies and compensation committees can still make a difference both in how effectively they comply with the new rules, as well as in the appeal of the "story" that they are able to tell. Here are some of our thoughts about steps companies should be taking:

- ▶ Companies will need to collect a large amount of data, much of it for the first time. They should begin now to organize how they will assemble and check the data they will need and to make sure that their disclosure controls and procedures are adequate to collect and verify all the required information on a timely basis regarding both compensation and related-person transactions.
- ▶ Companies and compensation committees will need to have a clear understanding of how their policies operate and be satisfied with the philosophy, policies and processes they will be required to describe. There is still time to modify the philosophy, policies and processes that will be reflected in the new CD&A and other narrative disclosure. In particular, policies and practices surrounding the timing and pricing of option grants should be examined and, where feasible, adjusted to reflect best practices that regularize those option granting processes.
- ▶ More than ever, compensation committees will want to consider how all the elements of compensation work together and how these elements will be presented in the disclosure. For example, compensation committee members may want to review a version of a tally sheet that conforms to the requirements of the SCT and other new tables or perhaps mock-ups of the new tables with proposed executive compensation reflected.

- ▶ With the new emphasis on disclosure of post-employment compensation, compensation committees should have a firm grasp on potential payouts under various scenarios played out on tally sheets. In particular, committee members should examine the post-employment compensation payable using the assumptions set forth in the new rules.
- ▶ Companies should view the new CD&A and other narrative disclosure as an opportunity to explain the strategies and purposes underlying compensation decisions, especially those that might appear questionable if not presented in the proper context. To that end, companies should begin now, if they have not already done so, to analyze critically the elements of their compensation philosophies and how they are reflected in their policies and practices. For example, it may no longer suffice to explain simply that the purpose of option grants is to align the interests of executives and shareholders. This may be especially true, for example, if the company has repriced its options or if the company has no security ownership requirements. Rather, companies may need to provide a more thorough analysis of the purposes, objectives and effects of their equity compensation programs. Companies may also want to consider whether additional performance-based vesting criteria may be appropriate for certain awards.
- ▶ Although the spotlight has been on the new CD&A, the new corporate governance disclosure regarding compensation committee procedures may turn out to be a “sleeper.” Compensation committees will need to report on their practices regarding delegation, the role of executives in making decisions regarding compensation and the use of consultants, topics that may be sensitive for some companies. As a result, companies should begin now to consider their approaches to this disclosure. In connection with this review, companies may want to

revisit certain traditional practices, such as engagement by the compensation committee of compensation consultants that are also engaged by management to perform other related services for the company or even selection by management of the consultants that will advise the compensation committee.

- ▶ Going forward, in making broad policy decisions or other compensation determinations, compensation committee members will want to be sure that they understand *why* any material change is being made, how it fits into the company’s compensation program as a whole and whether any adjustments should be made to other elements of compensation as a result.

Compliance Dates

Compliance will be required as follows:

- ▶ Forms 8-K reporting triggering events that occur 60 days or more after publication in the Federal Register;
- ▶ Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006;
- ▶ new proxy or information statements filed on or after December 15, 2006, that are required to include Regulation S-K, Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006; and
- ▶ Securities Act and Exchange Act registration statements (including pre-effective and post-effective amendments, as applicable), filed with the SEC on or after December 15, 2006, that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

As discussed at the end of this *Alert*, special transition rules will apply. ■

SUMMARY OF THE NEW RULES

EXECUTIVE & DIRECTOR COMPENSATION

The new disclosure requirements for executive and director compensation combine tabular elements to provide clarity and comparability with narrative elements to furnish context and facilitate understanding. The new CD&A will provide a narrative overview, while the compensation tables have been reorganized into three broad categories: a restructured SCT showing compensation for the last three fiscal years, holdings and exercises of equity-based interests that relate to current or potential gains, and much expanded tabular and narrative disclosure reporting retirement and other post-employment compensation. The SEC has emphasized that “all elements of compensation must be included in the tables.” Narrative accompanying the tables will add specific material information regarding the tables “where necessary to an understanding of the tabular disclosure.” Compensation of directors will also include tabular and narrative disclosure.

Copies of the new tables are attached to this *Alert* as Appendices.

Compensation Discussion and Analysis

The SEC’s director of the Division of Corporation Finance, John White, has characterized the new CD&A as the “heart” of the new compensation disclosure regime. Although the CD&A rules were adopted substantially as proposed, as discussed below under the caption “Option Grant Timing and Pricing Disclosure,” the key change from the original proposal is the requirement to include in the CD&A a discussion of option grant timing and pricing practices.

1. What type of information is required to be included in the CD&A?

The CD&A is designed to provide a principles-based, comprehensive narrative overview of executive compensation that puts into context the material elements of compensation of the named executive officers (NEOs) as quantified and disclosed in the tables and narrative that follow. The overview should include a discussion and analysis of the material factors underlying compensation policies, decisions and objectives, addressing both the separate elements of executive compensation as well as executive compensation as a whole. The instructions to the CD&A emphasize that the discussion should reflect the company's individual circumstances, avoiding boilerplate and repetition of the more detailed information in the tables and related narrative, although the discussion may specifically refer to the tables where appropriate. The new CD&A rules pose six broad questions regarding the objectives and components of, and processes involved in determining, executive compensation and provide a *non-exclusive* list of 15 examples of the types of issues that a company might want to consider in preparing its CD&A.

2. What do you mean by "principles-based"?

The requirements for the CD&A are "principles-based" in that they identify the disclosure concept and provide several illustrative examples. There are, however, no "bright-line" rules provided. Each company must then, using the examples as a guide, consider the application of the principles to its individual facts and circumstances and tailor the disclosure accordingly. Because the scope of the CD&A is intended to be comprehensive, the SEC emphasizes that the list of examples is non-exclusive and that a company must address its own compensation policies, even if not among the examples.

3. What are the broad questions that we must address?

While the precise content of the CD&A will vary depending upon each company's facts

and circumstances, the overview should respond to the following questions:

- ▶ what are the objectives of the company's compensation programs?
- ▶ what is the compensation program designed to reward?
- ▶ what is each element of compensation?
- ▶ why does the company choose to pay each element?
- ▶ how does the company determine the amount (and, where applicable, the formula) for each element?
- ▶ how do each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?

4. What are the SEC's illustrative examples of issues that would be appropriate to consider addressing in the CD&A?

Illustrative examples of issues provided in the rules include the following:

- ▶ the policies for allocating between long-term and currently paid-out compensation;
- ▶ the policies for allocating total compensation 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 (such as relationship of the award to the achievement of the company's long-term goals, management's exposure to downside equity performance risk, correlation between cost to the company and expected benefits to the company);
- ▶ 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 forms of compensation are structured and implemented to reflect these items of the company's performance, including whether discretion can be or has been exercised, identifying any particular exercise of discretion, and stating whether it applied to one or more specified NEOs or to all compensation subject to the relevant performance goals;
- ▶ how specific forms of compensation are structured and implemented to reflect the NEOs individual performance and/or individual contribution to these items of the company's performance, describing the elements of individual performance and/or contribution that are taken into account;
- ▶ company policies and decisions regarding the adjustment or recovery of awards or payments if the relevant company performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment;
- ▶ the factors considered in decisions to increase or decrease compensation materially from the prior year;
- ▶ 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);
- ▶ with respect to any change-in-control agreement, plan or arrangement, whether written or unwritten, the basis for selecting particular events as triggering payment obligations (e.g., the rationale for providing a single trigger for payment in the event of a change in control);
- ▶ the impact of the accounting and tax treatments of the particular form of compensation;
- ▶ the company's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), 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); and
- ▶ the role of executive officers in determining executive compensation.

5. Has the requirement to discuss our Section 162(m) tax policy been eliminated?

No. The example above regarding the impact of accounting and tax treatments indicates that any tax or accounting treatment regarding compensation, including Section 162(m), that is material to the company or to the NEOs is covered by the CD&A.

6. The CD&A sounds a lot like the Compensation Committee Report that we used to include in our proxy statement. How is the new CD&A different?

In some sense, the CD&A replaces the Compensation Committee Report, but the concept is more comprehensive and requires a more rigorous analysis that examines the material information necessary for investors to understand NEO compensation. John White has urged companies to view preparation of the CD&A as a “new project,” rather than simply a cut-and-paste of last year’s report.

7. Do we still need to include a Compensation Committee Report?

Yes. Under the final rules, a new abbreviated form of Compensation Committee Report, comparable to the current Audit Committee Report, will be required above the names of the committee. The Report will include a statement of whether the compensation committee has reviewed and discussed the CD&A with management and, based on this review and discussion, recommended to the board of directors that it be included in the company’s annual report on Form 10-K and proxy statement. As with the former Compensation Commit-

tee Report, it will be deemed to be “furnished” to the SEC, and not “filed.”

8. We were concerned by the requirement in the initial proposal that our CEO and CFO certify regarding the CD&A because, in effect, it requires them to certify as to matters from which they, under good governance principles, have been expressly excluded. Has that issue been addressed in the final rules?

To some extent. Notwithstanding significant objection from commenters on the proposal, the final rules continue to require that the CD&A be “filed” with the SEC and not “furnished.” As a result, when officers certify regarding the accuracy of the information in the Annual Report on Form 10-K, they will also be certifying regarding the CD&A, whether as a result of inclusion of the CD&A in the report or incorporation by reference from the company’s proxy statement. The rules provide, however, that certifying officers may “look to” the statements made by the compensation committee in the Compensation Committee Report to support their certifications. Nevertheless, certifying officers remain responsible for the information that is the subject of their certifications, and the new Compensation Committee Report will typically not be available until it is incorporated by reference into the Form 10-K from the company’s later proxy or information statement.

9. Will we need to discuss all officers separately in the new CD&A?

Where policies or decisions are substantially similar, officers may be discussed together as a group. Where, however, the policy for an executive officer is materially different, as may be the case for a CEO, his or her compensation should be discussed separately.

10. Under the old rules, when discussing performance-based compensation, we were not required to disclose our specific performance target levels. Has that changed under the new rules?

Generally no, but there is a slight change in emphasis. As was formerly the case, compa-

nies will not be required to disclose “target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any factors or criteria involving confidential commercial or business information, the disclosure of which would have an adverse effect on the company.” The adopting release makes clear, however, that, in applying this instruction, the SEC intends that companies use the same “competitive harm” standard commonly applied in determining “adverse effect” when seeking confidential treatment of portions of documents filed as exhibits because they contain “confidential trade secrets or confidential commercial or financial information” (Exemption 4 under the Freedom of Information Act). In addition, if a material performance target has otherwise been disclosed publicly, it must be disclosed in the CD&A.

11. Do you mean that we will actually need to seek confidential treatment of the target levels?

No. A company may make that determination independently; however, in the event that the company does not disclose specific target levels or other factors or criteria in reliance on the instruction, the CD&A will need to discuss the level of difficulty for the executive or the likelihood that the company will be able to achieve the undisclosed target levels or other factors. In addition, if the company’s CD&A is selected for review by the SEC staff, the company may be required to demonstrate to the satisfaction of the staff that the target involves confidential trade secrets or confidential commercial or financial information and that disclosure would result in competitive harm.

12. Will target levels be treated as non-GAAP financial measures requiring reconciliation to GAAP numbers?

No. However, for target levels that are based upon non-GAAP financial measures, the company must disclose how the number is calculated from the company’s audited financial statements.

13. The old Compensation Committee Report required discussion of only the preceding fiscal year. What time period must the CD&A cover?

Because the CD&A is designed to be a discussion of the information in the tables and narrative that follow it, the discussion will usually focus on compensation for the preceding fiscal year. However, the extent of the discussion will depend upon the particular facts at each company. The CD&A may also require discussion of post-termination compensation arrangements, ongoing compensation arrangements and policies that will apply prospectively, as well as actions that were taken after year-end, such as the adoption of new or modified programs or other specific decisions that were made or steps that were taken that could affect an investor's understanding of the NEOs' compensation for the last fiscal year. It may be necessary in some instances to discuss prior years to provide perspective.

RECOMMENDATIONS: The CD&A will require a significant amount of new analysis. Companies and their compensation committees should have a clear understanding of the nature of their compensation philosophies, how their policies operate and be satisfied with the philosophy and policies they will be required to describe. Compensation committees will want to review the CD&A with care. In addition, companies should anticipate that the new CD&A will come under intense SEC scrutiny, particularly for the first couple of years, and, as with MD&A, should make a special effort to focus on the "analysis" component of the title and to observe the SEC's admonition to avoid boilerplate disclosure. •

Summary Compensation Table

The SEC views the SCT (attached to this *Alert* as Appendix A) as the "principal disclosure vehicle for executive compensation." The SCT will reflect compensation awarded to, earned by or paid to each NEO

for each of the last three fiscal years and will be accompanied by explanatory narrative disclosure. As discussed below and under the caption "Option Grant Timing and Pricing Disclosure," a new Grants of Plan-Based Awards Table will supplement the SCT, providing greater detail about the timing and pricing of option grants.

1. How has the SCT been reorganized?

The principal changes to the structure of the SCT include the addition of two columns for equity-related disclosure, a new column showing non-equity incentive plan compensation, a new column reporting changes in pension value and nonqualified deferred compensation earnings, and a new column reporting total compensation. The new "total" column is designed to enhance comparability across companies and from year to year at the same company. The "other annual compensation" column has been eliminated. The five NEOs whose compensation is reported in the SCT must include, in addition to the PEO, the PFO and the three other most highly compensated executive officers.

2. We understand that now our CEO and CFO must always be included in the SCT. How do we identify the other three highest paid executive officers?

The three other most highly compensated executive officers would be determined by reference to total compensation, reduced by the amount reported under the column in the SCT for the increase in pension values and above-market or preferential earnings on nonqualified deferred compensation. The SEC agreed with the concerns of commenters that these eliminated elements could distort the selection of individuals as they principally reflect executives' decisions to defer compensation and wealth accumulation in pension plans or may be unduly influenced by age or years of service. In any event, to be included in the table, the executive's total compensation would have to exceed the threshold of \$100,000, the same dollar threshold as used under the former rules, but now based on the broader concept of "total compensation"

rather than just salary and bonus. The requirement to determine NEOs based on total compensation may require companies to collect and analyze data for a larger group of executives than in the past, where just the sum of salary and bonus was determinative.

3. One of our executives works in London and, as a result, receives a very substantial cost-of-living adjustment. In the absence of the adjustment, he would not be included in the SCT. Do we need to include him?

No. Cash compensation attributable predominantly to overseas assignments may be excluded from the calculation because, the SEC believes, these payments have the potential to skew the application of the disclosure away from executives whose compensation it would be more appropriate to report.

4. In the past we were able to exclude from the SCT an executive who received an unusually large amount of cash compensation that was not part of a recurring arrangement and was unlikely to continue, if the executive would otherwise not have been included in the SCT. Is that exclusion still available?

No. The receipt of an unusually large amount of cash will now be considered compensation for disclosure, even if it is not part of a recurring arrangement and is unlikely to continue. The SEC eliminated the exclusion in the new rules because of concern that inconsistent interpretation of the standard could give rise to manipulation.

5. Our CFO was terminated in the middle of the year, and we now have a new CFO. Do we need to provide disclosure for both individuals?

Yes. The company must provide disclosure for both individuals serving in that capacity, even if one was no longer serving in that capacity at the end of the fiscal year.

6. One of three most highly compensated executives was promoted to that position during the last fiscal year. Do we need to disclose compensation for the period prior to her becoming an executive?

Yes. If she served as an executive for any part of a fiscal year for which information is

required, the company must disclose all her compensation for the full fiscal year.

7. Do we still need to provide disclosure in the SCT for up to two former executives?

Yes. The SCT should include disclosure for up to two additional individuals for whom disclosure would have been required but for the fact that they were no longer serving as executive officers at the end of the last completed fiscal year.

8. Can we omit a column in the SCT if we have nothing to report there?

Yes.

9. We just became a public company. Do we still need to provide data for three years?

No. A company may exclude information for fiscal years prior to its last completed fiscal year if the company was not a reporting company at any time during that year (unless the SEC previously required the company to provide information for a prior year, presumably as part of its registration process).

10. Under a special arrangement we have with one of our customers, the salary of one of our executives is paid in part by the customer for special services he provides. We used to disclose that compensation in our proxy statement in the section captioned "Certain Transactions," but not in the SCT. Is that still the case?

No. In the new rules, disclosure *as compensation* is required for all transactions between the company and a third party where the primary purpose of the transaction is to furnish compensation to an NEO. Companies may no longer exclude disclosure regarding a compensatory transaction on the basis that it has been disclosed as a related-person transaction. Although in some cases, compensation information may be disclosed twice, instructions to the requirements for related-person transactions permit companies to omit disclosure as a related-person transaction where, among other things, the employment relationship and related compensation is reported as compensation.

11. Our acting CEO is also a director of the company and receives both salary and directors' fees. Should we report the directors' fees in the SCT?

Yes. Moreover, if her compensation as a director is disclosed in the SCT with footnote disclosure indicating the amount reflected in the table that is compensation for services as a director, disclosure will not be required to be included in the tabular disclosure regarding director compensation.

12. In the past, it was not possible to add up all the columns in the SCT because the information reflected in the column for "options" showed only the number of shares subject to options granted. How will we be able to calculate "total" compensation now under the new rules?

To provide a more complete picture of compensation and facilitate reporting total compensation, the SEC has modified the rules to require that all compensation be disclosed in dollars, including the dollar value for equity-based awards. These amounts will be shown in separate columns for stock and stock options, measured at grant date fair value, computed pursuant to Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123R).

13. Are we required to report cash or other compensation awarded but deferred?

Yes. If any compensation, whether or not cash, is currently payable but has been deferred for any reason, the deferred amount must be included in the appropriate column (and reflected as a contribution in the deferred compensation presentation, unless made pursuant to a qualified plan).

14. We have had occasions when we have not determined bonus amounts for the prior fiscal year until after the proxy statement has been distributed. In the past, we simply indicated in the proxy statement that bonuses have not yet been determined and reported the information the next year. Has that changed under the new rules?

In part. Companies will still be required to disclose in a footnote that the salary or

bonus is not calculable through the latest practicable date, but they will also now need to indicate the date that the amount is expected to be determined. In addition, a current report under Item 5.02 of Form 8-K would be triggered when the amounts do become calculable in whole or part, disclosing the salary or bonus amount and a new total compensation figure.

15. Is the "total" that is now shown in the SCT the same as the "total" we use to determine who are the three other highest paid executive officers?

No. The new "total" column will aggregate the total dollar value of each form of compensation reported in the preceding columns. As discussed above, the "total" compensation used to determine the NEOs excludes any amounts reported in the column showing the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation.

16. What information is required to be included under the three new plan-related columns?

The three new plan-related columns require the following:

- ▶ The "stock awards" column will disclose the dollar value of stock-related awards that derive their value from the company's equity securities or permit settlement by issuance of the company's equity securities (and are within the scope of FAS 123R for financial reporting), such as restricted stock, restricted stock units, phantom stock, phantom stock units, common stock equivalent units or other similar instruments that do not have option-like features. Stock awards granted pursuant to an equity incentive plan (defined below) are also included in this column for consistency purposes.
- ▶ The "option awards" column will report the dollar value of awards of options, SARs and similar equity-based compensation instruments that have option-like features and are within the scope of FAS 123R.

► The “*non-equity incentive plan compensation*” column will report the dollar value of all amounts earned under non-equity incentive plans, including all other incentive plan awards not included in the stock awards and option awards columns. Compensation that is not within the scope of FAS 123R will be disclosed in the year when the relevant specified performance criteria under the plan are satisfied and the compensation earned, whether or not payment is actually made in that year. (No further disclosure is required when the payment is actually made.) Note, however, that the grant will also be disclosed in the supplemental Grants of Plan-Based Awards Table in the year of grant, which may be prior to the year in which the grant is reported in the SCT. Earnings on outstanding non-equity incentive plan awards are also included in this column and should be identified and quantified in a footnote to the SCT.

17. How does the SEC define a “non-equity incentive plan”? An “equity incentive plan”?

A “non-equity incentive plan” is defined as an incentive plan (or portion of an incentive plan) that is not an “equity incentive plan.” Incentive plans are plans that provide an incentive for performance to occur over a specified period (i.e., that have a performance or market condition) whether performance is measured by financial performance, stock price or another performance measure. An “equity incentive plan” is “an incentive plan or portion of an incentive plan under which awards are granted that fall within the scope of FAS 123R.”

18. What is a “performance condition”?

Under FAS 123R, a performance condition is “a condition affecting the vesting, exercisability, exercise price or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee’s rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the

employer’s own operations (or activities). Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions for purposes of [FAS 123R]. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of [FAS 123R]. A performance target might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division or an individual employee.”

19. What is a “market condition”?

A “market condition” is “a condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award under a share-based payment arrangement that relates to the achievement of (a) a specified price of the issuer’s shares or a specified amount of intrinsic value indexed solely to the issuer’s shares or (b) a specified price of the issuer’s shares in terms of a similar (or index of similar) equity security (securities).”

20. How do we determine the value of equity-based awards? What about non-equity-based awards?

Valuation for *equity* awards is based on the grant date fair value of the award determined under FAS 123R for financial reporting purposes, regardless of whether the award itself is in the form of stock, options or similar instruments or the award is settled in cash but the amount of payment is tied to performance of the company’s stock. Because there is not one clearly accepted standard for measuring the value at grant date of *non-equity* incentive plan awards, grant date fair value will not be used for those awards. Rather, these awards will be reported in the SCT when earned.

21. Under FAS 123R, the compensation cost is generally recognized over the vesting period of the award. In the SCT, do we record only the amount recognized in our financial statements for that year, i.e., just the portion of the award expensed?

No. Under the new rules, the full amount of the compensation cost calculated as the grant date fair value will be shown as compensation in the year in which the grant is made. If a company does not believe that the full grant date fair value reflects compensation for the fiscal year, the SEC advises that the company may add appropriate explanation in the accompanying narrative. Companies must include a footnote to the SCT referring to the relevant discussion of the FAS 123R assumptions in the notes to the financial statements or MD&A (which discussion is also required in the company’s annual report to shareholders and is also deemed part of the SCT disclosure).

22. How are cash-settled SARs reported?

Even though cash-settled SARs are treated as “liability awards” under FAS 123R and do not have a grant date fair value, cash-settled SARs are reported under the “option awards” column using the FAS 123R value as if they were equity awards.

23. Our cash bonuses are granted after year-end, based upon the achievement of certain performance targets. Should these bonuses be reported under the “bonus” column or under the “non-equity incentive plan compensation” column?

Bonuses should be reported under the “non-equity incentive plan compensation” column if they are awarded under plans that provide incentives for performance to occur over a specified period, that is, “if the outcome with respect to the relevant performance target is substantially uncertain at the time the performance target is established and the target is communicated to the executive.” Only cash bonuses that are “based on satisfaction of a performance target that was not pre-established and communicated, or the outcome of which

is not substantially uncertain” (e.g., guaranteed sums without any requirement to achieve a performance goal) would be reported under the “bonus” column. In a rather anomalous result, because of these definitions, it is likely that most bonus amounts will be reported as compensation under the “non-equity incentive plan compensation” column, rather than under the “bonus” column.

24. Our awards are all subject to forfeiture if the employee terminates employment before a specified vesting period. When are those awards reported in the SCT?

Grants subject to forfeiture are still reported at the same times as other grants, i.e., for equity-based awards, with respect to the year of grant, for non-equity based awards, when the relevant performance condition has been satisfied (including an interim performance condition in a long-term plan). Subsequent forfeitures of amounts reported in the table with respect to previous fiscal years may be reported in the accompanying narrative.

25. Under the old rules, if we completed a repricing program during the year, we were required to show as new grants the full amount of the repriced option. Is that still the case? Does the SEC still require a 10-year repricing table?

No, to both questions. As is the case under FAS 123R, only the incremental fair value, computed as of the repricing or modification date, must be reported for a repriced award. In contrast, new awards that do not replace previously cancelled awards, such as reload options, will be reported based on total grant date fair value. Repriced awards are not to be included in the table for Grants of Plan-Based Awards; however, disclosure regarding repriced awards should be included in the narrative for that table and the SCT, as appropriate, as well as in the CD&A. The 10-year repricing table has been eliminated under the new rules.

26. One change we noticed from the proposal is the inclusion of a new column for “change

in pension value and nonqualified deferred compensation earnings.” What disclosure does this new column require?

This column requires disclosure of the following compensation:

- ▶ the aggregate increase in actuarial present value to each NEO of defined benefit and actuarial plans (plans that provide for the payment of retirement benefits or benefits that will be paid primarily following retirement, including tax-qualified defined benefit plans and supplemental executive retirement plans (SERPs), but excluding defined contribution plans, such as 401(k) plans) accrued during the year; and
- ▶ the above-market or preferential portion of nonqualified deferred compensation earnings, determined, as under the prior rules, for interest, by reference to 120% of the applicable federal long-term rate and, for dividends, by reference to the dividend rate on the company’s common stock. (Note that the entire amount will be disclosed in a separate table, as discussed below under “Post-Employment Compensation.”) The company’s criteria for determining any portion of earnings that is considered to be above-market and the company’s method of calculating earnings on deferred compensation plans are examples of factors that could be material and may be provided in footnote or narrative disclosure.

27. How is the increase in pension value determined?

The increase is calculated by reference to the change in the actuarial present value from year to year at the pension plan measurement date used for the company’s audited financial statements, including both increases in value attributable to an additional year of service, compensation increases and plan amendments (if any), and increases (or decreases) in value attributable to interest. The company must use the same assumptions it uses for financial reporting purposes under GAAP.

28. What information is required to be included under the “all other compensation” column?

This column discloses *all* other compensation not required to be included in any other column. Each item of compensation that exceeds \$10,000 must be separately identified and quantified in a footnote. The SEC encourages companies to use additional tables wherever tabular presentation facilitates clearer, more concise disclosure, such as to report a variety of perquisites or other forms of compensation reported in this column. Items to be reported in this column include:

- ▶ Perquisites and personal benefits that aggregate in excess of the new lowered threshold of \$10,000. Once that threshold is crossed, any perquisite or other personal benefit must be identified and, if it is valued at the greater of \$25,000 or 10% of total perquisites and other personal benefits, its value must be disclosed. Note that the only exception to the requirement to report *all* compensation is for perquisites and other personal benefits that in aggregate do not exceed the threshold of \$10,000.
- ▶ Tax gross-ups or other reimbursement of taxes for any compensation. These amounts must be separately quantified and identified as tax reimbursement, even if the associated perquisites or other personal benefits are eligible for exclusion.
- ▶ Amounts paid or accrued pursuant to a plan or arrangement in connection with any termination (or constructive termination) of employment or a change in control. Accrued amounts are amounts that have become due, such as a severance payment currently owed. Compensation resulting from business combinations other than pursuant to a plan or arrangement in connection with any termination of employment or change in control would be reported under the appropriate column of the SCT. (Non-plan examples might include a retention bonus, acceleration of option or stock vesting periods or performance-based

compensation intended to serve as an incentive for NEOs to acquire other companies.)

- ▶ Annual company contributions or other allocations to vested and unvested defined contribution plans, such as 401(k) plans, including, for example, employer matching contributions and profit-sharing contributions, but not including participant elective deferrals (because those amounts are already included in salary, bonus or other columns).
- ▶ The dollar value of any insurance premiums paid by the company with respect to life insurance for the benefit of an NEO.
- ▶ The compensation cost, if any, computed in accordance with FAS 123R, for any discount security of the company or its subsidiaries (purchased from the company or its subsidiary through deferral of salary or bonus), unless that discount is available generally either to all security holders or to all salaried employees of the company. Under FAS 123R, for example, no compensation is recognized (and, therefore, no disclosure would be required in this column) if the discount is five percent or less, all qualified employees can participate in the offer, and there are no option features.
- ▶ *The dollar value of any dividends or other earnings paid on stock or option awards* when the dividends or earnings were not factored into the grant date fair value. These amounts would be reported when the dividends or other earnings are paid.

Distributions of nonqualified deferred compensation and, unless accelerated pursuant to a change in control, benefits paid under defined benefit and actuarial plans are not reportable as “all other compensation.”

29. What is a “perquisite or personal benefit”?

The SEC maintains that the best way to define a “perquisite” is by first explaining what a perquisite is not: if an item is “integrally and directly related to the performance of the executive’s duties,” it is

not a perquisite, and no further analysis is required. Examples include BlackBerries or laptops that permit executives to be contacted outside the office—if these items are “integrally and directly related” to performance of the position, it would not matter if they are also used for personal benefit or if they involve an incremental increase over a less expensive alternative (for example, a mid-sized car over a compact car).

If an item does not satisfy the first test, then, in determining whether it is a perquisite, a company must consider whether the item 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 on a non-discriminatory basis to all employees.” Generally, following the SEC’s guidance, companies and their advisors determine whether particular items should be characterized as perquisites, and the SEC advises the relevant parties to approach the subject “thoughtfully.”

30. Please explain the concept of “integrally and directly related” to job performance? Is it really as narrow as it sounds?

Yes. As the SEC explains it, the concept is a “narrow one. The analysis draws a critical distinction between an item that a company provides because the executive needs it to do the job, making it integrally and directly related to the performance of duties, and an item provided for some other reason, even where that other reason can involve both company benefit and personal benefit.” Whether an item is a deductible expense for tax purposes or whether the company pays for an expense is not determinative.

31. But if the item is provided for the benefit or convenience of the company or otherwise for a business purpose, how can it be a perquisite?

It will be a perquisite under the SEC’s narrow definition unless it is also integrally and directly related to job performance. For example, the fact that a company policy requires executives to use company aircraft

at all times, including for personal travel, does not alter the determination that the use of company aircraft by the executive for vacations is a perquisite. Because the benefit is not integrally and directly related to job performance and because it confers a personal benefit not generally available to all employees, even if it also benefits the company, it would be considered a perquisite.

32. When is an item considered to be “generally available to all employees on a non-discriminatory basis”?

It would be considered generally available if it is available to those employees to whom it may be lawfully provided (e.g., it may be possible to exclude foreign employees or non-accredited investors under certain circumstances). It would not be considered to be generally available to all employees if the benefit were provided only to employees in the same job category or at the same pay scale.

33. Do you have any examples of items that the SEC views to be “integrally and directly related” to job performance, i.e., that are not perquisites?

In the proposing release, the SEC identified the following as examples of items that it would view as “integrally and directly related” to job performance:

- ▶ office space at a company business location, even if larger than that provided to other employees;
- ▶ a reserved parking space that is closer to business facilities but not otherwise preferential;
- ▶ additional clerical or secretarial services devoted to company matters;
- ▶ travel to and from business meetings;
- ▶ other business travel;
- ▶ business entertainment;
- ▶ security during business travel; and
- ▶ itemized expense accounts the use of which is limited to business purposes.

34. Can you provide examples of items that the SEC generally considers to be perquisites?

Examples of perquisites include:

- ▶ club memberships not used exclusively for business entertainment purposes;
- ▶ personal financial or tax advice;
- ▶ personal travel using vehicles owned or leased by the company;
- ▶ personal travel otherwise financed by the company;
- ▶ personal use of other property owned or leased by the company;
- ▶ housing and other living expenses (including but not limited to relocation assistance and payments for the executive or director to stay at his or her personal residence);
- ▶ security provided at a personal residence or during personal travel;
- ▶ commuting expenses (whether or not for the company's convenience or benefit); and
- ▶ discounts on the company's products or services not generally available to employees on a non-discriminatory basis.

35. Under the old rules, we were permitted to omit disclosure of information regarding group life, health, hospitalization, medical reimbursement or relocation plans that did not discriminate in scope, terms or operation in favor of NEOs or directors and were generally available to all salaried employees? Can we still omit that information?

For the most part, yes. However, because the SEC believes that relocation plans may be discriminatory *in operation* in favor of executive officers, the rules have been changed, and compensation under all relocation plans must now be disclosed.

36. Is it sufficient to identify perquisites generally by category, as in "travel and entertainment"?

No. Perquisites must be specifically identified, such as clothing, jewelry, artwork, theater tickets and housekeeping services,

\$6,000 shower curtains and antique umbrella stands.

37. How do we calculate the value of a perquisite?

The proper measure of the value of perquisites and other personal benefits is the "aggregate incremental cost to the company." In the release, the SEC cautions companies that the amount attributed to perquisites for federal income tax purposes is not necessarily the same as the incremental cost. Companies must also disclose in a footnote to the SCT the methodology for computing the aggregate incremental cost.

38. We understand that a supplemental table, the Grants of Plan-Based Awards Table, will now be required. What information is included in that table?

The Grants of Plan-Based Awards Table (attached to this *Alert* as Appendix B) is a complex table requiring a significant amount of detailed information, including, for each grant, disclosure of:

- ▶ the number of shares of stock or units subject to an award;
- ▶ the terms of grants made during the current year; and
- ▶ estimated future payouts for both equity incentive plans and non-equity incentive plans.

For incentive plan awards (both equity and non-equity), threshold, target and maximum payout information should be provided. Companies will not be permitted to aggregate option grants with the same exercise or base price: separate disclosure is required for each grant. If consideration is paid for an award, this information should be provided in a footnote to the appropriate column. In addition, as discussed below under the caption "Option Grant Timing and Pricing Disclosure," the new table requires detailed disclosure in order to provide more transparency in connection with option grant timing and exercise price selection.

39. It appears to us that the new tables will result in a lot of "double-counting" of compensation. How do we avoid confusing our shareholders?

The SEC acknowledges that the required tabular disclosures may result in a fair amount of double-counting. To address this problem, the SEC suggests that appropriate explanation be provided in the narrative accompanying the tables.

40. What do we report if we have made tandem grants?

Where there is a tandem grant of two instruments and only one of the instruments is granted under an incentive plan, only the instrument that is not granted under an incentive plan need be reported in the table, with the tandem feature noted.

41. What information should we provide if our incentive plan awards provide for only a single estimated payout?

If the award provides for only a single estimated payout, that amount should be reported as the target.

42. How does the narrative accompanying the tables differ from the CD&A?

The CD&A should focus on "broader topics regarding the objectives and implementation of executive compensation policies." The narrative disclosures following the SCT and other tables require companies to describe any additional material factors necessary to an understanding of the information disclosed in the tables and are intended to provide specific context for the tabular disclosure.

43. What is required in the narrative following the SCT and Grants of Plan-Based Awards Table?

Although the material factors requiring disclosure will vary depending upon the facts and circumstances, factors that could be material include:

- ▶ material terms of each NEO's employment agreement or arrangement;

- ▶ repricings or other material modifications of outstanding options or other equity-based awards, such as extension of exercise periods, change of vesting or forfeiture conditions, change or elimination of applicable performance criteria and change of the bases upon which returns are determined (other than as the result of a preexisting formula, such as an anti-dilution formula that affects all holders of the class);
- ▶ award terms relating to disclosure provided in the Grants of Plan-Based Awards Table, such as a general description of the formula or criteria to be applied in determining the amounts payable, the vesting schedule, a description of the performance-based conditions and any other material conditions applicable to the award, whether dividends or other amounts would be paid, the applicable rate and whether that rate is preferential; and
- ▶ an explanation of the amount of salary and bonus in proportion to total compensation.

Provisions regarding post-termination compensation need to be addressed in the narrative only to the extent disclosure of that compensation is required in the SCT. Both written and unwritten agreements should be covered.

44. There was a lot of press about the so-called “Katie Couric” provision, the requirement in the proposal to provide disclosure about the compensation paid to up to three non-executives whose compensation was greater than any of the NEOs. What happened to that provision in the final rules?

Although it was widely reported that the proposal to require disclosure of compensation to the three most highly paid employees, if higher than that paid to any NEO, would be eliminated, the SEC decided to modify and “repropose” the provision for further public comment. Public comments on the original proposal were largely opposed to the requirement, with concerns raised regarding competition, privacy and

cost. The staff believes that the revised version of the provision will address these concerns and help to provide context for NEO compensation. As reproposed, the provision would apply only to large accelerated filers (essentially, companies with public floats of \$700 million or more), and would not apply to the entire employee pool, but would rather exclude employees with no responsibility for significant policy decisions within the company, a significant subsidiary or a principal business unit, division or function. The SEC does not expect the provision as reproposed to cover athletes, traders, portfolio managers, movie stars or celebrity journalists in the performance of their typical duties. However, in light of the scope of the definition of responsibility for significant policy decisions (which includes the exercise of strategic, technical, editorial, creative, managerial or similar responsibilities), the provision may well have broader application than anticipated. SEC Commissioner Paul Atkins has observed that almost all highly paid employees would likely be involved in some type of policy-making, given the breadth of the definition.

The new proposal would require that the accompanying narrative disclosure include the total compensation (excluding the same items that would be deducted from total compensation for purposes of determining the NEOs) and job positions (but not names) of each of a company’s three most highly compensated employees (whether or not they were executive officers during the last completed fiscal year) whose compensation for the last completed fiscal year was greater than that of any of the NEOs included in the tables.

RECOMMENDATIONS: The new tables will require companies to collect, analyze and disclose extensive amounts of detailed data. Just determining the NEOs from year to year will require a more extensive effort than in the past because of the need to look at total compensation. Companies will need to commence the process of collecting

data earlier than in the past. Companies or committee consultants should provide to their compensation committees for review at least one variant of a tally sheet that conforms to the requirements of the new SCT prior to the committees’ final determinations of annual compensation. Moreover, companies will need to ensure that they have established adequate disclosure controls and procedures to provide the new disclosure on a timely basis, including personnel who have adequate familiarity with compensation-related issues. •

Option Grant Timing and Pricing Disclosure

The adopting release makes clear that the SEC does not express a view as to whether or not a company may have valid reasons for timing of option grants and selection of exercise prices, consistent with a company’s own business purposes. Moreover, both Christopher Cox and John White have emphasized that there is nothing inherently wrong with corporate practices related to selection of fortuitous grant dates and setting of below-market exercise prices, so long as the options granted are properly accounted for and the practices appropriately disclosed. Nevertheless, the options dating scandal has hardly escaped the SEC’s notice, and the new rules seek to address the problem with both tabular and narrative disclosure in the CD&A. While the CD&A disclosure requirements apply to executive officers, under the rules regarding disclosure of director compensation (discussed below), the same issues and considerations for disclosure of option timing or pricing practices applied in the context of executive compensation would also apply to stock options granted to directors.

1. What are the issues regarding option compensation that the SEC is seeking to address?

The SEC has identified two particular areas requiring additional disclosure:

- ▶ the timing of option grants (i.e., when companies grant options in coordination with the release of material information, whether positive or negative, whether involving the delay or acceleration of the grant or of the release of the information); and
- ▶ the establishment of exercise prices (i.e., setting of the exercise price at other than the market price on the grant date).

2. What additional tabular disclosure is required under the new rules to address these issues?

There are several elements of the new tabular disclosure designed to make option grant disclosure more transparent:

- ▶ In the SCT, grants of stock options will be reported at their fair value on the date of grant, as determined under FAS 123R, which is expected to provide to shareholders a more accurate picture of the value of options at the grant date;
- ▶ In the new Grants of Plan-Based Awards Table,
 - ▶ if the per-share exercise or base price of options, SARs and similar option-like instruments is less than the closing price per share of the underlying security on the grant date, a separate column must be added showing the closing price per share on the grant date, and
 - ▶ if the date on which the compensation committee (or comparable committee or the full board of directors) makes (or is deemed to make) a grant of an equity-based award is different from the date of grant determined for financial statement reporting purposes under FAS 123R, another separate column is required to report the date of committee or board action.

If the exercise or base price is not the closing market price per share on the grant date, companies must describe in the accompanying narrative the methodology for determining the exercise or base price.

3. As provided in our equity incentive plan, we price our options based on the closing price of the day preceding the date of grant. Will we need to include a separate column for that, even though our accountants have historically accepted that price as fair market value on the grant date?

Yes. As adopted, the rule requires a separate column if the company does not measure fair market value on the grant date by the *last sale price* on the principal U.S. market for the security *on the date of grant*. In addition, the company must provide a description of the methodology for determining the exercise or base price, either by footnote to the table or in the accompanying narrative.

4. What additional information is required in the CD&A to address these issues?

Of course, as with all principles-based disclosure, companies will need to consider their own facts and circumstances in preparing their disclosures. As discussed above (see question 4 under “Compensation Discussion and Analysis”), a number of the illustrative examples of issues to be considered in preparing the CD&A are either directly or indirectly applicable to option grant disclosure generally, including how the determination is made as to when awards are granted, including awards of equity-based compensation such as options, and the role of executive officers in determining executive compensation.

5. Are there specific issues to consider in connection with disclosure related to the timing of option grants?

Yes. If the company selects or, during the last fiscal year, selected, option grant dates for executive officers in coordination with the release of material non-public information (whether positive or negative, whether involving the delay or acceleration of the grant or of the release of the information), such as in closed “window periods” or in advance of disclosure of known favorable news, then the company should disclose its program, plan or practice of timing of grants, as well as that the board of directors

or compensation committee grants options at times when the board or committee is in possession of material non-public information.

In addition, the company should consider, among other issues, the following:

- ▶ How does any practice of timing option grants to executives fit in the context of the company’s practice, if any, with regard to timing of option grants to employees more generally?
- ▶ What was the role of the compensation committee in approving and administering the option plan or practice of timing of option grants?
- ▶ How did the board or compensation committee take the information into account when determining whether and in what amount to make those grants?
- ▶ Did the compensation committee delegate any aspect of the actual administration to any other persons?
- ▶ What was the role of executive officers in the company’s program, plan or practice of option timing?
- ▶ Does the company set the grant date of its stock option grants to new executives in coordination with the release of material non-public information?
- ▶ Does the company plan to time, or has it timed, its release of material non-public information for the purpose of affecting the value of executive compensation?

Disclosure would also be required if the company has done no more than adopt such a program, plan or practice or has made one or more decisions since the beginning of the past fiscal year to time option grants.

6. Are there issues to consider in connection with disclosure related to the establishment of option exercise prices?

If the company selects or, during the last fiscal year, selected, option exercise prices based on the stock’s price on a date other than the actual grant date (such as the lowest price in the month in which a new hire

grant was made) or had a plan or practice of 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, this plan or practice should be disclosed in the CD&A. An explanation of the reasons for the practice would also be appropriate. Questions similar to those raised above with respect to timing of option grants may also have application in this context. Once again, adoption of a plan or practice or making of decisions in this regard since the beginning of the past fiscal year would also require disclosure.

RECOMMENDATIONS: In addition to the obvious admonition to avoid practices that may be, or have the appearance of being, questionable or that may lead to ministerial record-keeping errors that raise accounting and disclosure issues, companies should consider adopting a series of best practices that regularize the timing and pricing of option grants. A number of these best practices were suggested in our *Alert* of June 5, 2006, "Stock Option Backdating: the Latest 'Hot Issue'" at www.cooley.com/news/alerts.aspx?ID=39704820. However, the new rules highlight the need for companies to review their practices to determine the nature of any disclosure that will be required and to examine whether there are any changes that would be advisable to improve or enhance their processes or to reduce the complexity of the required disclosure. For example, some companies with equity-based plans that specify that fair market value should be determined by reference to the last sale price on the date preceding the date of grant may want to consider whether they should amend their plans to change the definition of fair market value to the last sales price on the date of grant to simplify the disclosure in the Grants of Plan-Based Awards Table.

Depending upon the change, shareholder approval may be required for this type of amendment. In making that decision, however, companies should take into account, not just the disclosure requirements, but also best practices with respect to consistency of pricing as well as the committee members' desire to know the exercise price at the time of grant. •

Holdings and Exercises of Previously Awarded Equity

The new rules require two tables to reflect equity compensation. The first table reports awards outstanding at fiscal year-end; the second table reports the exercise or vesting of equity awards during the fiscal year.

Outstanding Equity Awards at Fiscal Year-End Table. This table (attached to this *Alert* as Appendix C) will indicate potential amounts that the NEOs could realize, depending upon the eventual stock price or outcome for the related performance metric. The table is divided into two parts, the first addressing options, SARs and other option-like awards and the second addressing stock awards, and is applicable to both in-the-money and out-of-the-money awards.

1. What information is required to be disclosed regarding awards of option-like instruments?

For option-like awards, companies must report:

- ▶ the number of securities underlying unexercised instruments that are exercisable;
- ▶ the number of securities underlying unexercised instruments that are unexercisable;
- ▶ the exercise or base price; and
- ▶ the expiration date.

2. What information is required to be disclosed regarding stock awards?

For stock awards, companies must report:

- ▶ the number of unvested shares, units or other rights; and
- ▶ the market or payout value of unvested shares, units or other rights.

3. So we don't need to report option vesting?

The vesting dates of options, stock and equity incentive plan awards must be reported in a footnote to the applicable column in the table.

4. Are we permitted to report on an aggregated basis?

Yes and no. Options, SARs and other option-like instruments must be reported on an individual basis, unless the expiration date and the exercise and/or base price of the instruments are identical. A single award consisting of a combination of instruments must be reported as separate awards with respect to each tranche with a different exercise or base price or expiration date. However, stock awards may be reported on an aggregate basis.

5. One of our executives has gifted some of his options to his children. Do the options still need to be reported?

Yes. Awards that have been transferred, other than for value, must be reported. The company will also need to disclose the nature of the transfer in a footnote to the table. Transfers for value would be reported in the Option Exercises and Stock Vested Table.

6. What types of awards are reported in the columns that relate to equity incentive plans?

This column is intended to report awards that are subject to a performance condition until the condition has been satisfied (or the award lapses without satisfaction of the condition). Once the performance condition has been satisfied, the awards would be reported in the appropriate option column, until exercise or expiration, or appropriate stock column, until vesting. Companies may want to consider adding footnote or narrative disclosure to explain the transition.

7. How do we determine the value of performance-based awards? Do we assume that performance has been achieved?

Instructions to the table indicate that information should be reported based on achieving threshold performance goals, unless the previous fiscal year's performance exceeded the threshold, in which event the next higher performance measure (target or maximum) that exceeds the previous fiscal year's performance should be used. If the award provides for only a single estimated payout, that amount should be reported. If the target amount is not determinable, companies should report a representative amount based on the previous fiscal year's performance.

Option Exercises and Stock Vested Table.

This table (attached to this *Alert* as Appendix D) will disclose the amounts that the NEOs have realized or earned from equity awards during the last fiscal year by reporting the amounts received upon exercise of options or similar instruments or the vesting of stock, such as restricted stock, restricted stock units or similar instruments during the most recent fiscal year. The table is divided with respect to option awards and stock awards.

8. What information is required to be disclosed in this table?

This table requires disclosure of the following:

- ▶ number of shares acquired upon exercise or vesting; and
- ▶ dollar value realized upon exercise (i.e., the excess of the market price of the underlying securities at exercise or vesting, as the case may be, over the exercise or base price to be paid for the stock) or vesting (i.e., the market value of the underlying shares multiplied by the number of shares).

9. You said that we will need to report transfers of options for value in this table. Where would that be reported?

Because transfers of awards (either options or stock) for value are considered realization

events, amounts realized upon these transfers must be reported in the appropriate "value realized" columns.

10. We have given tax gross-ups to our executives to cover any taxes payable. Do we include those payments in our calculations for this table?

No. The value of payments by the company to the executive for taxes or for the exercise price should not be included in the calculation of value realized in this table, but should be disclosed in the SCT under "all other compensation."

11. Do we need to report amounts realized but deferred?

Yes. A footnote quantifying the amount and disclosing the terms of the deferral should be included.

RECOMMENDATIONS: To minimize double-counting and other potential confusion, companies should consider adding, as necessary or appropriate, footnote or narrative regarding awards that appear in multiple tables or columns at various stages of the awards. •

Post-Employment Compensation

One of the components of executive compensation that has grown significantly, and has also been the subject of a substantial share of disquieting journalism, is post-employment compensation. The new rules include a revised pension table, a new table and narrative reporting nonqualified defined contribution plans and other deferred compensation and new expanded narrative disclosure regarding compensation arrangements triggered by termination or changes in control.

Pension Benefits Table. In a change from the former rules, the new table will provide information about specific pension benefits applicable to each of the NEOs.

1. What information does this table require?

The pension benefits table (attached to this *Alert* as Appendix E) requires disclosure of:

- ▶ the actuarial present value of the NEO's accumulated benefit under each defined benefit plan; and
- ▶ the number of years of service credited under the plan and payments during the last fiscal year.

2. How do we compute actuarial present value?

Actuarial present value will be computed using the same pension plan measurement date as used for financial statement reporting purposes with respect to the company's audited financial statements for the last completed fiscal year, without regard to the particular forms of benefit payment available under the plan. Companies must use the same assumptions, such as interest rate assumptions, as required under GAAP, but would assume that retirement age is normal retirement age as defined in the plan, or if not so defined, the earliest time at which a participant may retire under the plan without any benefit reduction due to age. The estimates are to be based on current compensation, without any estimate of future levels of compensation. The valuation method and all material assumptions must be described in the narrative accompanying the table.

3. How do we allocate the current accrued benefit between tax-qualified defined benefit plans and related supplemental plans?

For purposes of allocating the current accrued benefit between tax-qualified defined benefit plans and related supplemental plans, a company will apply the applicable Internal Revenue Code limitations in effect as of the pension plan measurement date.

4. What else is required in the narrative related to this table?

Issues to consider include:

- ▶ the material terms and conditions of benefits available under the plan, including the plan's retirement benefit formula and

eligibility standards, and early retirement arrangements;

- ▶ the specific elements of compensation, such as salary and various forms of bonus, included in applying the benefit formula, identifying each such element;
- ▶ regarding participation in multiple plans, the different purposes for each plan; and
- ▶ company policies with regard to such matters as granting extra years of credited service.

Nonqualified Deferred Compensation Table.

The SEC believes that nonqualified deferred compensation may represent a significant element of post-termination compensation. As a result, the new rules provide for a new table disclosing contributions, earnings and balances under these nonqualified plans.

1. What is required to be disclosed in this table?

The new Nonqualified Deferred Compensation Table (attached to this *Alert* as Appendix F) will be required to disclose contributions, earnings and balances under each nonqualified defined contribution or other plan that provides for the deferral of compensation. Disclosure will include:

- ▶ executive and company contributions in the last fiscal year;
- ▶ aggregate earnings in the last fiscal year;
- ▶ aggregate withdrawals and distributions; and
- ▶ aggregate balance at fiscal year-end.

2. Do we disclose only above-market or preferential earnings, as in the SCT?

No. The full amount of earnings must be disclosed.

3. Are 401(k) plans covered by this table?

No.

4. Some of this information may also be reported in the SCT. How do we minimize the confusion of double-counting?

To clarify the extent to which amounts payable as deferred compensation represent

previously reported compensation and not additional current compensation, companies will be required to quantify in a footnote amounts in the contributions and earnings columns of this table that are reported as compensation for the last completed fiscal year and other amounts reported in the table in the aggregate balance column that were reported in the SCT for prior years.

5. Is there a required narrative following this table as well?

Yes. The narrative should describe material factors necessary to an understanding of the disclosure in the table, including:

- ▶ the types of compensation permitted to be deferred and any limitations (by percentage of compensation or otherwise) on the extent to which deferral is permitted;
- ▶ the measures of calculating interest or other plan earnings (including whether these measures are selected by the NEO or the company and the frequency and manner in which the selections may be changed), quantifying interest rates and other earnings measures applicable during the company's last fiscal year; and
- ▶ material terms with respect to payouts, withdrawals and other distributions.

Where plan earnings are calculated by reference to actual earnings of mutual funds or other securities, such as company stock, it is sufficient to identify the reference security and quantify its return. This disclosure may be aggregated to the extent the same measure applies to more than one NEO.

Other Potential Post-Employment Payments. Although the former rules require disclosure about change-in-control and severance agreements, the SEC was concerned that material information about these agreements, such as potential payment, was being omitted. To address that perceived problem, the new rules require narrative disclosure of specific aspects of written or unwritten arrangements that provide for payments "at, following, or in connection with the resignation, severance, retirement or other termination (including constructive

termination) of a named executive officer, a change in his or her responsibilities, or a change in control of the company." The \$100,000 disclosure threshold has been eliminated.

6. What are the specific aspects of termination and change-in-control arrangements that must be disclosed in the narrative?

The specific items include:

- ▶ the specific circumstances that would trigger payments or the provision of other benefits, including perquisites and health care benefits;
- ▶ the estimated payments and benefits that would be provided in each covered circumstance, and whether they would or could be lump sum or annual, disclosing the duration and by whom they would be provided;
- ▶ how the appropriate payment and benefit levels are determined under the various circumstances that would trigger payments or provision of benefits;
- ▶ any material conditions or obligations applicable to the receipt of payments or benefits, including non-compete, non-solicitation, non-disparagement or confidentiality covenants (including both duration and provisions regarding waiver of breaches); and
- ▶ any other material factors regarding each contract, agreement, plan or arrangement.

Quantitative disclosure is required, and tax gross-up payments must also be described.

7. Do the new rules apply to payments that will be made due to a change in responsibility that is not the result of a change in control?

Yes.

8. In light of the elimination of the \$100,000 threshold, will we now have to disclose every post-termination perquisite, no matter how inconsequential?

No. For post-termination perquisites, the same disclosure and itemization thresholds used for the new SCT will apply.

Compensation of Directors

9. Our CEO's termination agreement provides for payments that vary depending upon the date of termination and his then-current level of compensation. How do we approach estimating his payments under that agreement?

The SEC has mandated that, when calculating amounts payable under those circumstances, companies should assume that:

- ▶ the triggering event took place on the last business day of the company's last completed fiscal year; and
- ▶ the price per share of the company's securities is the closing market price as of that date.

10. Some of the amounts that may be payable under our termination agreements are not really determinable now. How do we address that problem?

In the event of uncertainties as to amounts payable, the company will be required to make a reasonable estimate (or to disclose a reasonable estimated range of amounts). Material assumptions underlying the estimates must also be disclosed. These estimates will, however, be considered forward-looking information for purposes of applicable safe harbors, such as the Private Securities Litigation Reform Act, which requires that appropriate cautionary language accompany the information.

11. Does the SEC provide an example of "other material factors" that must be disclosed?

Yes. Other material factors might include, for example, whether an executive simultaneously receives both severance and retirement benefits, a practice commonly known as a "double dip."

12. One of our executives was terminated during the year. Do we still need to provide full disclosure and estimates regarding his change-in-control or other agreements?

No. If a triggering event has actually occurred for an executive and the executive is not serving as an NEO at fiscal year-end, the disclosure required would apply only to that particular triggering event.

13. You said that we need to report health care benefits. How do we calculate those?

Health care benefits should be quantified based upon the assumptions used for financial statement reporting purposes under GAAP.

14. We don't offer any retirement benefits to any executive that are not available to all salaried employees generally. Do we need to report those?

No. If the benefits are generally available to all salaried employees on a non-discriminatory basis, no disclosure is required of those benefits.

15. As we analyze our agreements, it appears to us that all amounts payable would already be disclosed under the Nonqualified Deferred Compensation Table. Do we need to repeat it all here?

No. If the form and amount of any payment or benefit is fully disclosed in the Pension Benefits Table or Nonqualified Deferred Compensation Table and the narrative disclosure related to those tables, companies need not repeat the disclosure and may simply refer to those tables and related narrative. However, if the triggering event would cause the form to change or the payment to increase or vest, the increase or acceleration of vesting must be specifically disclosed here.

RECOMMENDATIONS: The detailed requirements for disclosure of post-employment payments may be another example of the SEC's efforts to regulate by humiliation. If they have not already done so, compensation committees should take this opportunity to "run the numbers" for their post-termination and change-in-control arrangements, using a variety of scenarios suggested by the assumptions specified in the new rules. Committees that are not pleased with appearance of the results of that exercise may want to try to address those issues now, to the extent feasible. •

In light of the increasing complexity of compensation provided to directors, the SEC has expanded the disclosure of directors' compensation from solely narrative form to formatted tabular disclosure, accompanied by narrative of additional material information. In addition, the disclosure requirements regarding timing and pricing of option grants awarded to executives must also be applied to grants to directors.

1. Is the table for directors' compensation the same as the SCT for executives?

Largely, yes. The columns in the Director Compensation Table (DCT) (attached to this *Alert* as Appendix G) generally mirror those in the SCT, and the same SCT instructions govern analogous matters in the DCT. However, the DCT presents information only for the last completed fiscal year.

2. We allow our directors a choice of whether to be paid in cash or in stock. Are those fees reported together in the DCT?

No. Fees paid in cash, including retainers and meeting fees, are reported in the first column. Fees paid in stock would be reported under "stock awards."

3. What do we report under the "all other compensation" column?

In the DCT, companies should report under "all other compensation" all compensation paid to any director not properly reported in another column of the DCT, including:

- ▶ all perquisites and other personal benefits, if the total is \$10,000 or greater;
- ▶ all tax reimbursements;
- ▶ the compensation cost, if any, computed in accordance with FAS 123R, for any discounted security of the company or its subsidiaries (purchased from the company or its subsidiary through deferral of fees or otherwise), unless that discount is available generally either to all security holders or to all salaried employees of the company;

- ▶ amounts paid or accrued under a plan or arrangement in connection with the resignation, retirement or any other termination of a director or a change in control of the company;
- ▶ annual company contributions to vested and unvested defined contribution plans;
- ▶ all consulting fees;
- ▶ awards under director legacy or charitable awards programs; and
- ▶ the dollar value of any insurance premiums paid by, or on behalf of, the company for life insurance for the director's benefit.

Items, other than perquisites, with a value in excess of \$10,000 must be identified and quantified in a footnote to the column. Perquisites must be identified and quantified consistent with the requirements for executives in the SCT.

4. What amount do we report for director legacy programs?

In connection with a director legacy program (typically, a program under which the company agrees to make a future donation to charitable institutions in the director's name, payable upon a designated event, such as death or retirement), companies should disclose in the DCT the annual cost of the promises and payments, with footnote disclosure of the total dollar amount and other material terms of each program.

5. We understand that there is only one table, the DCT, required to report directors' compensation. Does that mean that we don't have to report the detailed information about options and other awards?

No, but the reporting requirement is not as extensive as it is for executives. In a footnote to the DCT, companies will need to report only the aggregate numbers of shares subject to stock awards and option awards outstanding at fiscal year-end.

6. All of our outside directors receive exactly the same fees and other payments. Can we group them together in the DCT?

Yes. An instruction to the DCT allows companies to group together multiple directors in a single row if all of the elements and amounts of their compensation are identical.

7. Under the old rules, we were required to disclose even *de minimis* perquisites provided to directors. Has that problem been rectified in the new rules?

Yes. Under the new rules, the threshold for reporting of perquisites is the same as for NEOs. That is, if all perquisites received by the director aggregate less than \$10,000, no disclosure is required.

8. Is there a requirement for narrative disclosure accompanying this table?

Yes. The narrative should address any material factors necessary to an understanding of the table, such as a breakdown of types of fees paid and any different compensation arrangements, identifying the director and describing the terms of the arrangement. In addition, the same issues and considerations for disclosure of option timing or pricing practices applied in the context of executive compensation would also apply to stock option grants to directors.

RECOMMENDATIONS: Companies should consider how best to use the narrative related to the DCT to convey their policies and practices with respect to director compensation, especially to the extent that perquisites or consulting arrangements form a substantial component of compensation. •

RELATED-PERSON TRANSACTIONS

Although the revisions to the related-person transactions disclosure has not received the widespread attention devoted to the changes to executive compensation, the modifications in this area are certainly far-reaching. The revisions streamline and completely restructure the disclosure requirements of

Regulation S-K, Item 404, making it much less prescriptive and more principles-based. As amended, the new Item 404 has been restructured as follows:

- ▶ Item 404(a) contains a general disclosure requirement for related-person transactions, including those involving indebtedness;
- ▶ Item 404(b) requires disclosure regarding the company's policies and procedures for the review, approval or ratification of related-person transactions; and
- ▶ Item 404(c) requires disclosure regarding promoters and certain control persons of a company.

Revised Item 404(a) consists of a general statement of the principle for disclosure, followed by specific disclosure requirements and instructions related to coverage, scope, methodology and other matters. The requirements for disclosure of indebtedness have been consolidated into this Item.

1. What is the broad disclosure principle articulated in Item 404(a)?

Item 404(a) will require 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;
- ▶ in which the amount involved exceeds \$120,000; and
- ▶ in which any related person had or will have a direct or indirect material interest.

2. Does "direct or indirect material interest" have the same meaning as under the prior rules?

Generally, yes. Although the specific instruction to that effect has been eliminated as redundant, a company must disclose a transaction if the related person had or will have a direct or indirect material interest in the transaction. The materiality of any interest will continue to be

determined on the basis of the significance of the information to investors in light of all the circumstances, taking into account the relationship of the related persons to the transaction, and with each other, the importance of the interest to the person having the interest and the amount involved in the transaction.

3. If a related-person transaction involves an amount in excess of the \$120,000 threshold, must it automatically be disclosed?

No. As in the past, a company should still evaluate whether the related person has a direct or indirect material interest in the transaction to determine if disclosure is required. Nevertheless, historically, most companies have been very reluctant to omit disclosure of transactions that exceed the threshold without substantial support for the proposition that the related person's interest was not material and, as a practical matter, we expect that practice to continue.

4. What is the significance of the revision requiring the company to be a "participant" in the transaction, as opposed to a "party"?

The change makes clear that disclosure will be required even if the company is not technically a party to the contract involved in the transaction, but nevertheless benefits or otherwise participates in the transaction.

5. There doesn't seem to be any reference to transactions involving subsidiaries. Do transactions involving subsidiaries still require disclosure?

Yes. Although the reference was deleted as superfluous, companies must still include subsidiaries in making materiality determinations in all circumstances.

6. Can you illustrate how the integration of indebtedness into the general disclosure principle will work now?

Yes. As an example, disclosure would be required with respect to an indebtedness transaction between the company and a third party exceeding \$120,000 if an executive officer had a material indirect interest

in the other entity as a result of his share ownership of the other entity.

7. Does the integration of "indebtedness" into the general disclosure principle mean that we will need to disclose indebtedness transactions with significant shareholders?

No. The amendments do not require disclosure of indebtedness transactions with significant shareholders (or their immediate family members). Disclosure would be required, however, if the significant shareholder or immediate family member were also a related person, such as an executive officer.

8. What is a "transaction" under the new rules?

A "transaction" is broadly defined to include any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships, specifically including indebtedness and guarantees of indebtedness.

9. How is "related person" defined?

The term "related person" means any person who, at any time during the period specified, was:

- ▶ a director or executive officer of the company and his or her immediate family members;
- ▶ if disclosure were 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; or
- ▶ a security holder known to the company to beneficially own more than five percent of any class of the company's voting securities (or any immediate family member of any such person) (referred to as a significant shareholder below), when a transaction in which the security holder or family member had a direct or indirect material interest occurred or existed.

10. Are there any changes to the definition of "immediate family member"?

Yes. The amended definition will now include stepchildren, stepparents, 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.

11. How will we be able to determine who are immediate family members of significant shareholders and whether there are any transactions with them?

Companies will need to distribute questionnaires to all significant shareholders to ascertain this information. Note, however, that shareholders are under no obligation to complete and return the questionnaires.

12. Last year we had a transaction with one of our directors before he became a director. Would we need to report that transaction?

Yes, so long as he was a "related person" during *any part* of that year. This requirement would not apply, however, to significant shareholders or their immediate family members, except where a transaction begins before the shareholder becomes a significant shareholder, and continues (for example, through the ongoing receipt of payments) at or after the time that the person becomes a significant shareholder.

13. How do we determine the amount involved in a transaction?

"Amount involved" is defined to mean the dollar value of the transaction or series of similar transactions, including:

- ▶ 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
- ▶ 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. Note, however, that *disclosure* of indebtedness will include the

largest aggregate amount of principal outstanding during the period for which disclosure is provided, as well as the amount of *principal and interest paid* during the period, the aggregate amount of principal outstanding as of the latest practicable date, and the rate or amount of interest payable on the indebtedness.

14. If we have determined that disclosure is required, what do we need to disclose?

The company will be required to describe the transaction, including:

- ▶ the person's name and relationship to the company;
- ▶ the person's interest in the transaction with the company, including the related person's position or relationship with, or ownership in, a firm, corporation or other entity that is a party to or has an interest in the transaction;
- ▶ the approximate dollar value of the amount involved in the transaction and of the related person's interest in the transaction (without regard to profit or loss); and
- ▶ any other information regarding the transaction or the related person in the context of the transaction that would be material to investors in light of the circumstances of the particular transaction.

15. If the transaction involves an asset purchase, do we still need to disclose the cost of the assets to the seller?

Only if the information would be material, for example, if the recent purchase price to the related person were materially less than the sale price to the company, or if the sale price to the related person were materially more than the recent purchase price to the company.

16. Do we still need to disclose as loans amounts owed to the company under Section 16(b) of the Exchange Act?

No.

17. Must executive compensation be disclosed as a related-person transaction?

Typically, no. Disclosure of compensation to an executive officer will not be required if:

- ▶ the compensation is reported under the compensation disclosure requirements (Regulation S-K, Item 402); or
- ▶ the compensation would have been so reported under Item 402 had the executive officer been an NEO, the compensation was approved, or recommended to the board for approval, by the compensation committee (or group of independent directors performing a similar function) and the executive officer is not an immediate family member.

Similarly, director compensation is not required to be disclosed as a related-person transaction if it has been disclosed under director compensation. Compensation not within these exceptions, such as compensation of immediate family members, would, however, be reportable as related-person transactions.

18. Do all debt transactions need to be disclosed? What about a credit card purchase or other ordinary course transactions?

There are a number of exclusions from the requirement to disclose indebtedness, including amounts due for purchases of goods and services subject to usual trade terms, for ordinary business travel and expense payments and for other transactions in the ordinary course of business. There is also a special exception if the lender is a bank, savings and loan association or broker-dealer.

19. One of our directors is also a director of our biggest customer. Does that mean that she has an "indirect material interest" in those sales, requiring disclosure as related-person transactions?

Not necessarily. As in the former rules, an instruction to the new rules provides that a person with a position at another entity will not be deemed to have "an indirect material interest" if:

- ▶ the interest arises only:
- ▶ from the person's position as a director of another corporation or organization that is a party to the transaction; or

- ▶ from the direct or indirect ownership by such person and all other related persons, in the aggregate, of less than a 10% equity interest in another person (other than a partnership) which is a party to the transaction; or
- ▶ from both such position and ownership; or
- ▶ the interest arises only from the person's position as a limited partner in a partnership in which the person and all other related persons, have an interest of less than 10%, and the person is not a general partner of and does not have another position in the partnership.

20. Are there any other exceptions to the disclosure requirements?

Yes. Related-person transaction disclosure is not required for any transaction:

- ▶ where the rates or charges involved in the transaction are determined by competitive bids, or the transaction involves the rendering of services as a common or contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority;
- ▶ involving services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture or similar services; or
- ▶ where the interest of the related person arises solely from the ownership of a class of equity securities of the company and all holders of that class of equity securities of the company received the same benefit on a pro rata basis (for example, receipt of dividends).

21. Do we need to disclose even transactions in the ordinary course of business that involve related persons?

There is no exception for transactions in the ordinary course of business. However, the SEC notes that, in assessing materiality for purposes of disclosure, companies may take into account whether the transaction was material and was undertaken in the ordinary course of business and on the

same terms generally offered to unrelated third parties.

22. Under the old rules and SEC interpretations, we did not have to disclose a transaction between the company and a supplier, even though one of our directors was CEO of that supplier and the value of the transactions exceeded the threshold of \$60,000 (now \$120,000), as long as the relationship was solely a business relationship that did not afford our director any special benefits and the amount involved did not exceed five percent of either our or the supplier's consolidated gross revenues (the disclosure threshold under former Regulation S-K, Item 404(b)). Is that exception still available?

No. There is no rule under the new amendments that is equivalent to former Item 404(b) (directors' business relationships) and, in the absence of further guidance from the SEC, the interpretation would no longer be valid, with the result that the scope of disclosure for directors has been substantially expanded.

23. You said that new item 404(b) requires a description of the company's policies and procedures for the review, approval or ratification of 404(a) transactions. What is required to be disclosed?

The description must include the material features of the policies and procedures that are necessary for an understanding of them, including:

- ▶ the types of transactions that are covered;
- ▶ the standards to be applied;
- ▶ the persons or groups of persons on the board or otherwise responsible for applying the policies and procedures; and
- ▶ whether the policies and procedures are in writing and, if not, how they are evidenced.

Any 404(a) transactions that are not required to be reviewed or approved must be identified. Similarly, disclosure must be made if the applicable policies and procedures have not been followed.

24. We had a transaction with an individual who later became an executive. What do we need to disclose about our policy?

Disclosure of a policy would not be required for any transaction that occurred before the triggering relationship commenced, so long as the transaction did not continue after commencement.

25. What disclosure do we need to provide about transactions with "promoters"?

If the company had a promoter at any time within the past five years (a change from the former rules, which required disclosure only if the company was organized within the past five years), the company must disclose:

- ▶ the names of the promoters;
- ▶ the nature and amount of anything of value received by each promoter from the company and the nature and amount of any consideration received by the company; and
- ▶ additional information regarding any assets acquired by the company from the promoter.

The same disclosure is required for any person who acquired control, or is part of a group that acquired control, of a shell company.

26. Is this disclosure required in all documents?

No, it is required only in registration statements on Forms S-1, SB-2, 10 or 10-SB.

RECOMMENDATIONS: The principles-based nature of the new disclosure requirements is a significant change from prior rules, requiring more exercise of judgment and less parsing of rules. In particular, companies will need to substantially rethink and, hopefully, simplify their standard D&O questionnaires, to the delight of most directors and of first-year associates who were previously called upon to explain to directors the maze of detailed questions required under the prior rules. •

OTHER CHANGES

Corporate Governance

In something of a housekeeping measure, the SEC is consolidating the corporate governance disclosure requirements in new Regulation S-K, Item 407. However, the new Item does contain some changes, including more direct disclosure about the determination of the independence of directors and expanded disclosure regarding compensation committees.

Independence of Directors. The amendments require companies to identify their independent directors (and nominees in proxy statements) under the applicable independence definition, as well as any members of the compensation, nominating or audit committees that are not independent under the applicable definition.

1. How do we determine the applicable independence standard?

If the company is listed on a national securities exchange or inter-dealer quotation system of a national securities association that has requirements that a majority of the board of directors be independent, it should use the definition of independence for directors (and for committee members) that the exchange or system uses for determining compliance with the applicable listing standards.

2. We are traded on the Pink Sheets. Should we use the Pink Sheets' independence standard, if there is one?

No. Inter-dealer quotation systems such as the OTC Bulletin Board, the Pink Sheets and the Yellow Sheets do not impose listing standards or have listing agreements with issuers. As a result, they are not within the definition.

3. But we are no longer listed on any exchange or inter-dealer quotation system. What standard do we use?

Companies that are not listed may select a definition of independence of a national

securities exchange or a national securities association. However, they will be required to apply the same definition consistently to all directors and to use the independence standards of the same exchange or association in determining the independence of committee members.

4. We don't have a nominating or compensation committee. What are we required to report regarding committee independence?

If the company does not have a separately designated compensation, nominating or audit committee or committees performing similar functions, the disclosure regarding independence under committee independence standards must be provided for all members of the board.

5. We are listed on Nasdaq, but rely on the "controlled company" exemption from the independence requirements. What do we need to disclose?

The company must disclose the exemption relied upon and explain the basis for its conclusion that the exemption is applicable. Similar disclosure is required for those companies that are not listed issuers but would qualify for an exemption under the listing standards selected.

6. Do we need to disclose the actual independence definitions?

The company must disclose whether its independence definitions are posted on its web site. If they are not posted, then they must be included as an appendix to the proxy statement at least once every three years (or the current proxy statement, if materially amended since the beginning of the last fiscal year). If not posted on the web site, in years when they are not included as an appendix, the company must disclose the last year when they were so included.

7. One of our directors whom we have characterized as independent did have a very minor transaction with the company. Do we need to disclose it?

Only if the transaction was not disclosed under Item 404(a) and was considered by

the board in determining independence. If so, the transaction should be described by specific category or type, on a director-by-director basis, with sufficient detail to permit the nature of the transactions, relationships or arrangements to be "readily apparent."

8. One of our directors resigned during the year. Do we still need to include the independence disclosure for that director?

Yes. The independence disclosure is required for any person who served as a director of the company during any part of the year even if the person no longer serves as director at the time of filing or is not standing for reelection. However, disclosure will not be required of any director who served *only prior* to a company's initial public offering.

Committees. The amendments eliminate some of the duplication and inconsistencies of the former rules. For example, as with the charter of the nominating committee, the audit committee charter will no longer be required to be delivered to shareholders if it is posted on the company's web site. In addition, the compensation committee disclosure requirements have been expanded.

9. Do the same "post or furnish" disclosure requirements apply to the charter of the compensation committee as apply to the charters of the audit and nominating committees?

Yes.

10. What are the other new disclosure requirements for compensation committees?

The company will be required to describe its processes and procedures for the consideration and determination of executive and director compensation including:

- ▶ the scope of authority of the compensation committee (or persons performing the equivalent functions);
- ▶ the extent to which the compensation committee may delegate authority to others, specifying the authority that may be so delegated and the persons to whom it may be delegated;

▶ any role of executive officers in determining or recommending the amount or form of executive and director compensation; and

▶ any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying the consultants and describing whether they were engaged directly by the compensation committee or by others, the nature and scope of their assignments and the material elements of the instructions or directions given to the consultants in connection with the performance of their duties. (Note that disclosure would not be required if an employee of a consulting firm met with company management to work on matters not involving compensation.)

11. This disclosure seems redundant. How is it different from the CD&A?

The SEC views the two disclosure requirements as distinct: this disclosure is designed to focus "on the company's corporate governance structure that is in place for considering and determining executive and director compensation – such as the scope of authority of the compensation committee and others in making these determinations, as well as the resources utilized by the committee." The SEC intends the CD&A to focus instead on "material information about the compensation policies and objectives of the company and ... to put the quantitative disclosure about named executive officer compensation into perspective."

12. Do we still need to provide information about compensation committee interlocks?

Yes.

RECOMMENDATIONS: The new requirement for narrative regarding compensation committee procedures has not drawn the same attention as the CD&A, but may turn out to be something of a "sleeper." Compensation committees will need to report on their practices

regarding delegation, the role of executives in making decisions regarding compensation and the use of consultants, topics that may be sensitive for some companies. As a result, companies should begin now to consider their approaches to this disclosure. •

Form 8-K

Item 1.01 of Form 8-K requires current reporting regarding entry by a company into, or material amendment of, a material definitive agreement, applying generally the same materiality standard as has been applicable to the determination of whether an agreement must be filed as an exhibit (Regulation S-K, Item 601(b)(10)(iii)(A) and (B)). The SEC has stated that this standard was intended to elicit disclosure of matters that were “unquestionably or presumptively material.” However, it appears that application of the exhibit standard triggered, in the staff’s view, a deluge of unnecessary executive compensation disclosures. As a result, the SEC has made changes intended to rein in the volume of disclosure by reorganizing the Form to combine the disclosure regarding NEOs and directors under a revised Item 5.02, which applies to departure and appointment of directors and certain officers, and by eliminating the reference to the exhibit filing standard to determine materiality under that Item.

1. Under the former rules, the requirement to file an 8-K to report entry by a director or NEO into an executive compensation arrangement did not except arrangements that are “immaterial in amount or significance.” Has that been changed in the new rules?

Yes. The SEC has “uncoupled” the exhibit standard from the determination regarding materiality of executive compensation agreements and arrangements for 8-K purposes. Specifically, employment compensation arrangements have been eliminated from the scope of Items 1.01 and 1.02 of Form 8-K, and Item 5.02 has been expanded

to cover those compensatory arrangements. New Item 5.02 will now trigger an 8-K filing in the event of:

- ▶ adoption, entry into or other commencement of any material compensatory plan, contract or arrangement (whether or not written, whether involving cash or equity);
- ▶ any new material grant or award under any such plan, contract or arrangement; or
- ▶ any material amendment to any compensatory plan, contract, arrangement, grant or award,

in each case, that applies to the PEO, PFO or other NEOs. Unlike Item 1.01, Item 5.02 does not make reference to the materiality standard of Item 601(b)(10) applicable to the determination of whether an agreement must be filed as an exhibit. The 8-K should provide a brief description of the terms and conditions of the plan, award or arrangement, including the amounts payable to the officers under it. The SEC emphasized in the adopting release that the descriptions are intended to be brief.

2. We have previously disclosed and filed copies of our executive bonus plan. Do we still need to report an award under it?

Not necessarily. Grants or awards (or their modifications) will not trigger an 8-K filing if they are materially consistent with “previously disclosed terms” of plans or arrangements and they are disclosed the next time the company is required to provide new compensation disclosure under Item 402 of Regulation S-K.

3. We just created a special bonus plan for an executive vice president who was not among the NEOs in our last proxy statement. In light of the new bonus arrangement, we expect her to be among the NEOs in our next proxy statement. For purposes of determining whether to report her new bonus plan under Item 5.02(e), should she be considered an NEO?

No. A new instruction advises that the NEOs are the persons named as NEOs in the company’s last filed SCT, presumably,

so long as the person is not the PEO or PFO, who are separately named.

4. Has the SEC also expanded the group of persons for whom disclosure regarding retirement, resignation or termination is required?

Yes. Information regarding retirement, resignation or termination must now also be provided under Item 5.02 for all NEOs for the company’s previous fiscal year, in addition to the officers and directors previously specified under the rule (the PEO, PFO, president, principal accounting officer, principal operating officer or persons performing similar functions).

5. You indicated previously that we might need to file an 8-K when we determine bonus amounts if we were not able to report those amounts in the SCT in our proxy statement. What do we need to report?

If salary or bonus amounts cannot be calculated for the last fiscal year and included in the company’s SCT, when there is a payment, grant, award, decision or other occurrence that allows the calculation to be made in whole or in part, an 8-K filing will be triggered. The report should disclose salary or bonus for the most recent fiscal year that was not available at the latest practicable date in connection with SCT disclosure, including a new total compensation recalculation to reflect the new salary or bonus information.

6. Is there anything new that we need to report in connection with the appointment of officers or the election of directors under revised Item 5.02?

Yes. Revised Item 5.02 will now require, with regard to the appointment of covered officers (the PEO, PFO, president, principal accounting officer, principal operating officer or persons performing similar functions) or the election (except by the shareholders) of directors, a brief description of any material plan, contract or arrangement entered into or materially amended, or any grant or award to them, or modification of the grant or award, under any plan, contract or arrangement in connection with these triggering events.

7. Does the SEC's safe harbor under Rule 10b-5 and exclusion from the Form S-3 eligibility requirements apply to revised Item 5.02?

Only in part. In restructuring Form 8-K, the SEC decided to extend the safe harbor and S-3 eligibility exclusion (that is, the exception under which companies that did not timely file an 8-K under certain Items could nevertheless continue to be eligible to use Form S-3) to paragraph (e) of Item 5.02, the paragraph that triggers reporting for a new compensatory plan or material amendment for NEOs. However, the other paragraphs of Item 5.02 are not covered by this exception. As a result, the departure or election (but not by the shareholders) of a director, appointment of an officer (and the compensation arrangements or agreements entered into in connection with those events) and other Item 5.02 triggers will continue to be triggering events that, if not timely reported, could result in the loss of Form S-3 eligibility.

8. If we file a Form 8-K that applies to multiple items, but inadvertently omit to include the captions for all of the required items, could we have a defective filing?

Possibly. If a company files a single Form 8-K to satisfy multiple disclosure items, it must identify each applicable item number and caption and provide all of the required substantive disclosure applicable to the Item. In the revised 8-K rules, the SEC has generously modified this requirement to permit companies to omit the Item 1.01 heading in a Form 8-K that also discloses any other item, so long as the substantive disclosure required by Item 1.01 is included in the Form 8-K. This act of charity has not been extended, however, to the omission of any other Form 8-K Item.

RECOMMENDATIONS: These revisions to Form 8-K may help restore some sanity to process of executive compensation disclosure. Unfortunately, however, the changes may not go far enough, and there remains a fairly intricate set of reporting requirements that will continue

to elicit a substantial number of filings. In particular, because the application of the safe harbor and Form S-3 eligibility exclusion does not extend to Item 5.02 in its entirety, companies will need to continue to monitor these events closely, particularly in light of the subjective determinations that may need to be made under this Item. •

Beneficial Ownership Disclosure

Regulation S-K, Item 403, requires disclosure of beneficial ownership of equity securities by directors (and nominees), NEOs and five percent shareholders. These amendments modify Item 403(b).

1. What changes are being made to the beneficial ownership requirements?

Item 403(b) is being amended to add a requirement for footnote disclosure of the number of shares pledged as security by the NEOs, directors (and nominees).

2. What is the purpose of the change?

Instigated, perhaps, by concerns arising out of the WorldCom fiasco (in which significant pledges of WorldCom shares by the CEO are considered by some to be the tipping point for the entire debacle), this revision reflects concerns by the SEC that shares used as collateral may be subject to material risks or contingencies that have the potential to influence management's performance and decisions. Accordingly, the SEC believes the information could be material to shareholders and should be disclosed.

RECOMMENDATIONS: Companies will need to revisit their D&O questionnaires to ensure that information regarding pledged shares is elicited. In addition, companies may also want to revisit their internal policies relating to share pledges by management. •

Conforming Amendments

The substantial revisions to the executive compensation and related-person disclosure requirements necessitate various conforming amendments, such as changes to Regulation BTR and to Rule 16b-3, as well as numerous other rules.

1. What are the changes to Rule 16b-3?

The "Non-Employee Director" definition of Rule 16b-3, in part, uses Item 404 as a basis to determine status as a Non-Employee Director. The elimination of former paragraph (b), business relationships of directors, from Regulation S-K, Item 404, requires conforming changes to that definition.

2. Has the SEC used these changes as an opportunity to make any other modifications to Rule 16b-3?

Yes. For purposes of determining status as a Non-Employee Director, the director must satisfy the definition's tests at the time he or she votes to approve a transaction. The SEC has added a new note to clarify that, with respect to Item 404(a), a company may rely on the disclosure provided under Item 404 for the company's most recent fiscal year contained in the most recent filing in which Item 404 disclosure is presented.

3. What if the transaction was reported for the prior year, but terminates before the vote?

If a disclosed transaction has terminated prior to the director's proposed service as a Non-Employee Director, the terminated transaction will not prevent the director's service.

4. Then what impact would a contemplated transaction have on service as a Non-Employee Director?

A current or contemplated transaction that could require Item 404(a) disclosure could taint the director's eligibility. The SEC notes that, to retain the director's status as Non-Employee Director, the company must "believe in good faith that any current or

contemplated transaction in which the director participates will not require Item 404(a) disclosure, based on information readily available to the issuer and the director at the time such director proposes to act as a Non-Employee Director. At such time as the issuer believes in good faith, based on readily available information, that a current (or contemplated) transaction with a director will require Item 404(a) disclosure in a future filing, the director no longer is eligible to serve as a Non-Employee Director.” Companies may rely on information they obtain from directors, for example, pursuant to a response to an inquiry.

5. Would a determination that a director’s contemplated transaction will require Item 404(a) disclosure be applied retroactively?

No. This determination will not have retroactive effect to taint a previously approved transaction.

RECOMMENDATIONS: If companies intend to rely on approval by Non-Employee Directors for purposes of Rule 16b-3, they should reexamine the composition of their compensation committees to be sure that the directors continue to satisfy the revised Non-Employee Director definition. •

6. We recall that the SEC proposed to eliminate the “performance graph.” Was that proposal adopted?

No. But the performance graph requirement has been moved from the proxy statement to the glossy Annual Report to Shareholders.

Plain English Disclosure

The SEC is adding two new rules, Rules 13a-20 and 15d-20, that will now require that most of the disclosure called for by the amended rules be provided in plain English.

1. Which sections are affected by the plain English requirement?

Any disclosure in an Exchange Act report under the following Items of Regulation S-K will be required to be in plain English:

- ▶ Item 402, executive compensation;
- ▶ Item 403, security ownership of certain beneficial owners and management;
- ▶ Item 404, transactions with related persons, promoters and certain control persons; and
- ▶ Item 407, corporate governance.

Under the new rules, if these disclosures are incorporated by reference into an Exchange Act report from a company’s proxy or information statement, the disclosure is required to be in plain English in the proxy or information statement.

2. Remind us, what is “plain English” anyway?

As the SEC defines it, “plain English” requires application of the following principles:

- ▶ present information in clear, concise sections, paragraphs and sentences;
- ▶ use short sentences;
- ▶ use definite, concrete, everyday words;
- ▶ use the active voice;
- ▶ avoid multiple negatives;
- ▶ use descriptive headings and subheadings;
- ▶ use a tabular presentation or bullet lists for complex material, wherever possible;
- ▶ avoid legal jargon and highly technical business and other terminology;
- ▶ avoid frequent reliance on glossaries or defined terms as the primary means of explaining information;
- ▶ define terms in the glossary or other section of the document only if the meaning is unclear from the context;
- ▶ use a glossary only if it facilitates understanding of the disclosure; and
- ▶ in designing the presentation of the information, include pictures, logos, charts, graphs, schedules, tables or other design elements so long as the design is not misleading and the required information

is clear, understandable, consistent with applicable disclosure requirements and any other included information, drawn to scale and not misleading.

In addition, companies should avoid:

- ▶ legalistic or overly complex presentations that make the substance of the disclosure difficult to understand;
- ▶ vague “boilerplate” explanations that are overly generic;
- ▶ complex information copied directly from legal documents without any clear and concise explanation of the provisions; and
- ▶ disclosure repeated in different sections of the document that increases the size of the document but does not enhance the quality of the information.

3. We recall that one of the past requirements of plain English was to avoid the use of footnotes. Don’t the new rules require us to include numerous footnotes?

Yes. That tenet of plain English seems to have been eliminated from these new rules.

4. So does that mean that this enormous release will be easy to read and understand because the SEC has written it in plain English?

Don’t count on it.

RECOMMENDATIONS: Writing in plain English may require some practice, even for the SEC, but it appears to be the wave of the future. •

TRANSITION

During the transition period, reporting under the new rules will be phased in, and companies will not be required to “restate” compensation or related-person transaction disclosure for fiscal years previously reported in accordance with the prior rules.

1. If we don't restate prior years, does that mean we present one SCT under the new rules and one SCT under the old rules?

No. For the first year, only the most recent fiscal year will be required to be presented in the SCT, and information for years prior to the most recent fiscal year will not have to be reflected at all. For the subsequent year, the SCT will be required to present only the two most recent fiscal years, and thereafter, all three fiscal years will be required to be reported in the SCT.

2. We're a calendar-year company planning to file our IPO registration statement in November. Do we use the old rules or the new rules?

Because the company's IPO registration statement will be filed before the effective date of the new rules, the company would present information under the old rules, but if the registration statement does not become effective until after the SCT and other compensation disclosure must be updated in 2007, then the company will need to file an amendment that includes 2006 compensation information presented in compliance with the new rules. The SCT will need to present only 2006 information.

3. What about related-person transactions disclosure? Is there a phase-in for that as well?

Yes. During the three-year phase-in period, companies will not be required to present prior years' Item 404(a) disclosure under the former rules.

RECOMMENDATIONS: Companies planning IPOs may want to consider early adoption to avoid having to restructure the disclosure if their registration statements are not declared effective before updated information is required. The SEC staff has recently indicated that early adoption will be permitted after the effective date so long as all of the new rules are adopted; companies will not be permitted to choose among the new rules. •

FINAL WORDS

The SEC's new rules and amendments will mean extensive changes to executive compensation disclosure, and the expanded scope and depth of disclosure may trigger a reexamination of the processes by which compensation is determined and even of the nature and amount of compensation itself. In light of these changes, companies will want to review their disclosure controls and procedures and ensure that their compensation committees are well-acquainted with the new rules and their effects on the companies' compensation disclosure.

If you would like to discuss any of these issues further, please contact a member of your Cooley team or one of the attorneys identified at the beginning of this *Alert*. ■

Appendix D

Option Exercises and Stock Vested

Name	Option Awards		Stock Awards	
	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise (\$)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting (\$)
(a)	(b)	(c)	(d)	(e)
PEO				
PFO				
A				
B				
C				

Appendix E

Pension Benefits

Name	Plan Name	Number of Years Credited Service (#)	Present Value of Accumulated Benefit (\$)	Payments During Last Fiscal Year (\$)
(a)	(b)	(c)	(d)	(e)
PEO				
PFO				
A				
B				
C				

Appendix F

Nonqualified Deferred Compensation

Name	Executive Contributions in Last FY (\$)	Registrant Contributions in Last FY (\$)	Aggregate Earnings in Last FY (\$)	Aggregate Withdrawals/Distributions (\$)	Aggregate Balance at Last FYE (\$)
(a)	(b)	(c)	(d)	(e)	(f)
PEO					
PFO					
A					
B					
C					

Appendix G

Director Compensation

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 (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
A							
B							
C							
D							
E							