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E-NEWSLETTER

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Business Law Update

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THE SEC ADOPTS FINAL CHANGES TO COMPENSATION DISCLOSURE RULES

On August 11, 2006, the Securities and Exchange Commission (SEC) published final amendments to its disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters, and stock ownership of executive officers and directors. This disclosure appears in proxy and information statements of public companies, as well as periodic, current and other reports under the Securities Exchange Act of 1934 (the Exchange Act). The amendments were originally proposed on January 27, 2006, and were adopted with relatively minor modifications after the receipt by the SEC of more than 20,000 comment letters. As described in more detail below, the new rules are generally effective for fiscal years ending on or after December 15, 2006, which is in time for the 2007 proxy season.

Executive and Director Compensation Disclosure

The goal of the new rules is to improve disclosure of all elements of executive and director compensation, and thereby give both shareholders and compensation committees clear, concise and meaningful information to allow them to reach informed decisions about compensation. The SEC's rules address disclosure and not the substance of executive compensation, and the SEC has emphasized that its rules do not seek to promote or require any given direction or level of executive compensation. Given the recent controversy over option backdating, the final rules also expand the required disclosure regarding stock options and option programs, including narrative discussion in the new Compensation Discussion and Analysis section.

Under the final amendments, compensation disclosure will begin with a narrative overview pursuant to the new Compensation Discussion and Analysis section. Following the Compensation Discussion and Analysis, the new rules organize the detailed disclosure of executive compensation in three broad categories:

- tabular and narrative disclosure of compensation to the named executive officers with respect to the last three fiscal years, principally through the amended Summary Compensation Table;
- tabular and narrative disclosure of holdings of equity-related interests that relate to compensation or are potential sources of future gains; and
- retirement and other post-employment compensation for executives.

Finally, the SEC also adopted a director compensation table that is similar to the amended Summary Compensation Table, but only covers the last completed fiscal year.

Compensation Discussion and Analysis. This new section will be the focal point of the new compensation rules. The Compensation Discussion and Analysis will provide narrative disclosure of a public company's compensation disclosure and objectives without resorting to boilerplate. It will precede the more detailed compensation numbers and narrative and will be designed to put the numbers and narrative into perspective for investors, and focus on the most important factors underlying each company's compensation policies and decisions. Key elements of the final rules include:

- The Compensation Discussion and Analysis section will be filed with the SEC and will be covered by the certifications of the principal executive officer and the principal financial officer filed under the Sarbanes-Oxley Act of 2002. This proposal generated a number of negative comments based on the fact that, in accordance with corporate governance reforms, compensation decisions should be made by the compensation committee without the presence of the principal executive officer and the principal financial officer, and so it may be difficult for those officers to certify as to the compensation objectives. Nonetheless, the SEC retained this requirement.
- The final rules do not eliminate the compensation committee report. The compensation committee report will require a statement of whether the compensation committee has reviewed and discussed the Compensation Discussion and Analysis with management and, based on such review and discussion, recommended that it be included in the Form 10-K and proxy statement. Like the current compensation committee report, and unlike the Compensation Discussion and Analysis itself, the new compensation committee report will be furnished rather than filed.
- The final rules also do not eliminate the performance graph. However, the performance graph will be moved from the compensation disclosure in the proxy statement to the disclosure covering the market price of common equity and related stockholder matters in the Form 10-K. The performance graph will continue to be furnished rather than filed.

In its release promulgating the final amendments, the SEC emphasized that the Compensation Discussion and Analysis must be principles-based and tailored to the unique circumstances of each particular company.

Responding to recent controversy involving stock option practices of public companies, the Compensation Discussion and Analysis section will also require enhanced narrative disclosure about option grants to executive officers. Companies must analyze and discuss the timing of stock option grants, including any program, plan or practice to time option grants to executives in coordination with the release of material non-public information.

Tabular and Narrative Disclosure. Following the Compensation Discussion and Analysis, detailed disclosure of executive officer compensation will be presented in revised tables, accompanied by narrative disclosure.

- ***Summary Compensation Table.*** The Summary Compensation Table (see the new form of the table below) will continue to serve as the principal disclosure for executive compensation and will continue to cover the last three completed fiscal years. Components of the new Summary Compensation Table include the following:
 - o salary and bonus columns, which are retained substantially in their previous form;

- o separate columns for stock-related awards (including phantom stock type awards) and option awards which will disclose the dollar value for the awards based on the grant date fair value under FAS 123(R);
- o a single column for non-stock incentive plan compensation;
- o a new column reporting the annual change in the actuarial present value of accumulated pension benefits as well as above-market or preferential earnings on nonqualified deferred compensation;
- o a single column for all other compensation, which includes perks unless the aggregate amount of such perks is less than \$10,000; and
- o a new column reporting total compensation during each covered fiscal year.

Name and Principal Position (1)	Year	Salary	Bonus	Stock Awards	Option Awards	Non-Equity Incentive Plan Compensation	Change in Pension Value and Nonqualified Deferre ^d Compensation	All Other Compensation	Total
Principal Executive Officer...									
Principal Financial Officer...									
A									
B									
C									

The "named executive officers" covered by the table will include any person who served as principal executive during the last completed fiscal year, any person who served as principal financial officer during the last completed fiscal year and the other three most highly compensated executive officers during the last fiscal year based on total compensation (less the amount in the column relating to pension benefits and nonqualified deferred compensation) whose total compensation exceeded \$100,000. In addition, as was the case under the previous rules, up to two additional individuals for whom disclosure would have been required but for the fact that they were not serving as executive officers at the end of the last completed fiscal year must be included.

- *Grants of Plan-Based Awards Table.* This table includes information regarding non-stock grants of incentive plan awards, stock-based incentive plan awards and awards of options, restricted stock and similar instruments during the last completed fiscal year.
- *Outstanding Equity-Awards at Fiscal-Year End Table.* This table shows outstanding awards for the named executive officers, with such information as the number of shares underlying exercisable and unexercisable options, exercise prices and expiration date for each outstanding option.
- *Option Exercises and Stock Vested Table.* This table shows amounts realized on equity compensation by the named executive officers during the last fiscal year, either upon exercise of stock options or vesting of other stock awards.
- *Pension Benefits Table.* This table will require disclosure of the actuarial present value of each named executive officer's accumulated benefit under each pension plan, computed using the same assumptions and measurement period as used for financial reporting purposes under GAAP.
- *Nonqualified Deferred Compensation Table.* This table will require disclosure of executive contributions, company contributions, withdrawals, all earnings for the year (not just the above-market or preferential portion) and the year-end balance.

These tables will be accompanied by narrative disclosure of additional material factors necessary to an understanding of the information disclosed in the tables. Information that may be disclosed includes a summary of employment agreements with named executive officers, any repricing or other material modification of any outstanding option or other stock-based award held by a named executive officer (note that the ten-year option repricing table has been eliminated), award terms for cash and stock-based awards, waivers or modifications of performance goals or targets for awards, and information regarding defined benefit and deferred compensation plans. Narrative disclosure of post-employment payments payable to named executive officers will also be required, such as contractual or other rights to severance or change of control payments and other benefits, with expanded disclosure of the details of such arrangements.

The final rules did not adopt the proposed narrative disclosure of compensation for up to three employees who were not executive officers during the last completed fiscal year but whose total compensation was greater than that of any of the named executive officers (the so-called "Katie Couric" proposal). Instead, the SEC re-proposed it in a modified form principally by excluding employees having no responsibility for significant policy decisions within the company, a significant subsidiary or a principal business unit and limiting the provision to large accelerated filers. This proposal will be subject to additional comment before it can be adopted as a final rule.

Director Compensation. For disclosure of director compensation, a table will be required that includes total compensation, cash fees, stock and option awards, non-stock incentive plan compensation, change in pension value and nonqualified deferred compensation earnings, and all other compensation (including perks subject to a \$10,000 aggregate threshold like the Summary Compensation Table). This table is similar to the Summary Compensation Table for the named executive officers, but only covers the last completed fiscal year. Footnotes to the table will include details such as outstanding equity awards at fiscal year end. Following the table, narrative disclosure will be required to describe any material factors necessary to an understanding of the table.

Revisions to Form 8-K

In the final rules, the SEC revised the disclosure requirements for Form 8-K reports as follows:

- Amending Item 1.01 and Item 1.02 of Form 8-K to eliminate employment compensation arrangements and covering such arrangements under a modified Item 5.02 of Form 8-K. Item 5.02 of Form 8-K currently provides for the reporting of the appointment or departure of a director or a principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions.
- Expanding the persons covered by Item 5.02 of Form 8-K to include all named executive officers for the company's previous fiscal year in addition to the other officer categories specifically covered by Item 5.02.
- Expanding the disclosure items covered under Item 5.02 to cover any material compensatory plan, contract or arrangement, or any grant or award, to a covered officer or director entered into in connection with such covered officer's or director's appointment or departure.
- With respect to named executive officers for the company's previous fiscal year, any new material compensatory plan, contract or arrangement would be a triggering event requiring a filing under Item 5.02. However, disclosure would not be required for a grant or award or modification thereto if consistent with the terms of previously disclosed plans or arrangements and if reported the next time the company is required to provide new disclosure under Item 402 of Regulation S-K.
- Adding a requirement to file a Form 8-K under Item 5.02 to report salary or bonus for the most recent fiscal year not available in connection with disclosure in the proxy statement under Item 402 of Regulation S-K. This most commonly applies if a company files its proxy statement before it has determined a bonus payout based on performance during the prior fiscal year. This disclosure will also require a new total compensation recalculation to reflect the new salary or bonus information.

The limited safe harbors regarding Rule 10b-5 and Form S-3 eligibility in the event a company fails to timely file a Form 8-K have been extended to certain of these new disclosure requirements under Item 5.02 of Form 8-K.

Beneficial Ownership Disclosure

The final rules amend Item 403(b) of Regulation S-K to require footnote disclosure of the number of shares pledged as security by named executive officers, directors and director nominees. This requirement does not apply to 5% stockholders who are not otherwise covered by the rule.

Disclosure of Related Party Transactions

The amendments streamline and clarify the disclosure of related party transactions pursuant to Item 404 of Regulation S-K by doing the following:

- Increase the dollar threshold for disclosure under Item 404(a) from \$60,000 to \$120,000. Under amended Item 404(a), a company must disclose any transaction since the beginning of the company's last fiscal year, or any currently proposed transaction:

- o in which the company was or is to be a participant (rather than only if a company is a party);
 - o in which the amount involved exceeds \$120,000; and
 - o in which any related person had, or will have, a direct or indirect material interest.
- Related persons include any director or executive officer of the company and his or her immediate family members (as well as director nominees for disclosure in a proxy statement). In addition, a 5% shareholder and such shareholder's immediate family members are also related persons.
 - Disclosure under Item 404(a) includes any indebtedness transaction and the separate rule on indebtedness in Item 404(c) has been eliminated. The current exception for disclosure of indebtedness transactions with a bank remains if the loan is not disclosed as nonaccrual, past due, restructured or potential problems. Disclosure of indebtedness of 5% shareholders is not required.
 - With regard to directors or executive officers (and their immediate families), disclosure is required if the person was a related person during any part of the last fiscal year. Such disclosure is not required for a 5% shareholder unless the person had that status at the time of the transaction or if the transaction begins before the person becomes a 5% shareholder and continues on or after becoming a 5% shareholder (such as through the ongoing receipt of payments).
 - Also excepted from disclosure under Item 404(a) are executive or director compensation transactions reported pursuant to Item 402 of Regulation S-K.
 - Item 404(b) requires disclosure of the company's policies and procedures for approving related party transactions. Such disclosure may include:
 - o the types of transactions that are covered;
 - o the standards to be applied;
 - o the persons or groups of persons on the board who are responsible for applying such policies and procedures; and
 - o whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.
 - Current Item 404(b), which establishes additional disclosure requirements for certain relationships of a company with a director (such as investment banking or legal services), is eliminated.

Corporate Governance Disclosure

The final amendments consolidate and expand the disclosure requirements regarding director independence and related corporate governance disclosure requirements under Item 407 of Regulation S-K. These disclosure requirements include the following:

- identification of the independent directors of the company and the standards used to determine independence (non-listed companies need to determine independence for this purpose by selecting the definition of a national securities exchange, such as the New York Stock Exchange or NASDAQ);

- if a company has adopted a definition of independence, it must disclose whether that definition is posted on the company's web site and, if not, it must include the definition as an appendix to the proxy statement at least once every three years;
- for each director identified as independent, a company must disclose, by a general description by category or type, any transactions, relationships or arrangements not disclosed pursuant to Item 404(a) of Regulation S-K that were considered by the board of directors in determining that the applicable independence standards were met as to each director or nominee;
- consistent with current disclosure requirements for the nominating committee charter, the audit committee charter can be disclosed on the company's web site rather than attached as an appendix to the proxy statement at least once every three years; and
- the disclosure regarding the compensation committee has been expanded to be consistent with disclosure currently required regarding the audit committee and the nominating committee, including disclosure of the following
 - o the scope of authority of the compensation committee;
 - o the extent to which the compensation committee may delegate any authority to other persons;
 - o if the compensation committee has a charter and, if so, the company's web site address at which a current copy is available (or, if not available on the web site, attaching the charter to the proxy statement at least once every three years);
 - o any role of executive officers in determining or recommending the amount or form of executive and director compensation; and
 - o any role of compensation consultants in determining or recommending the amount or form of executive or director compensation, identifying such consultants, stating whether the consultants were engaged by the compensation committee or any other person, and describing the nature and scope of their assignment and the material elements of their instructions. The proposed requirement to identify any executive officer contacted by the consultants in carrying out their assignment was not adopted.

Small Business Issuers

The amended disclosure requirements for executive and director compensation continue to differentiate between small business issuers and other issuers. Key elements of the new executive and director compensation disclosure requirements for small business issuers include the following:

- small business issuers will not be required to provide a Compensation Discussion and Analysis section or the related Compensation Committee Report;
- the Summary Compensation Table changes for small business issuers will largely track those applicable to other issuers, but information will only be required for the last two fiscal years and only for the principal executive officer and the two most highly compensated executive officers other than the principal executive officer;

- small business issuers will need to include the Outstanding Equity Awards at Fiscal Year-End Table, but not the Grants of Plan-Based Awards Table, the Option Exercises and Stock Vested Table, the Pension Plan Benefits Table or the Nonqualified Deferred Compensation Table; and
- small business issuers will need to provide the new Director Compensation Table.

Amended Item 404 of Regulation S-B is substantially similar to amended Item 404 of Regulation S-K, subject to the following:

- Regulation S-B does not include a requirement for disclosure relating to the policies and procedures for reviewing related party transactions; and
- Regulation S-B provides for a disclosure threshold equal to the lesser of \$120,000 or 1% of the average of the small business issuer's total assets at year-end for the last three completed fiscal years.

New Item 407 of Regulation S-B regarding corporate governance matters is substantially identical to new Item 407 of Regulation S-K.

Plain English

Most of the new disclosure under Items 402, 403, 404, and 407 must be provided in plain English under the SEC's established plain English guidelines currently applicable to prospectuses.

Compliance

The SEC adopted the final rules in time to be in effect during the 2007 proxy season. The compliance dates for the new rules are as follows:

- for the changes to Form 8-K, compliance is required for triggering events that occur 60 days or more after publication in the Federal Register;
- for Form 10-K and 10-KSB reports, compliance is required for fiscal years ending on or after December 15, 2006;
- for proxy and information statements, compliance is required if filed on or after December 15, 2006 and the filing is required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006; and
- for Securities Act registration statements (including pre-effective and post-effective amendments, as applicable), compliance is required if filed on or after December 15, 2006 and the filing is required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

Companies will not be required to "restate" compensation or related party transaction disclosure for prior fiscal years under the new rules, resulting in a three-year transition period under the new rules (two years for small business issuers). This means, for example, that only most recent fiscal year will be required in the revised Summary Compensation Table for the first proxy statement for which the new rules are effective, and then two years in the revised Summary Compensation Table for the proxy statement for the following year.

What to Do Now

The SEC's rule amendments are extensive and complex, and companies should begin to plan for implementation as early in advance of the 2007 proxy season as they can. It may be helpful to begin to prepare a mock-up of the 2007 proxy statement under the new rules to identify significant areas of change. Other steps to consider include the following:

- Working with the compensation committee to take a close look at compensation policies in order to develop the new Compensation Discussion and Analysis section.
- Developing a written policy regarding stock option grants.
- Developing written policies and procedures for the consideration and approval of related party transactions for purposes of the new disclosure requirement in Item 404(b) of Regulation S-K.
- Considering policies and procedures to determine director independence given the new disclosure requirements in Item 407 of Regulation S-K.
- Considering the role and functions of the compensation committee in view of the new disclosure requirements in Item 407 of Regulation S-K.
- Reviewing the impact of the new rules on the company's disclosure controls and procedures, including the effective identification of perks and other elements of compensation.
- Developing a new form of director and officer questionnaires.

This update is intended to provide a summary about new regulatory developments and should not be considered legal advice. If you have any questions or would like assistance regarding the matters discussed in this client alert, please call your regular Reinhart contact or one of the following members of our securities team:

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