

The SEC Proposes Significant Changes to Compensation Disclosure

On January 27, 2006, the Securities and Exchange Commission (SEC) published proposed 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 proposed rules are subject to public comment and will likely change before they are adopted and become effective. However, given the current focus on executive compensation practices of public companies, it is likely that the bulk of these proposed changes will be adopted, probably before the end of 2006 and in time for the 2007 proxy season.

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Executive and Director Compensation Disclosure

The proposed rules would expand and reorganize compensation disclosure in proxy and information statements through four general categories:

- a new Compensation Discussion and Analysis section;
- compensation tables for executive compensation with accompanying narrative disclosure;
- post-employment compensation for executives; and
- director compensation.

These compensation rules are generally contained in Item 402 of Regulation S-K, which would be significantly revised under the SEC's proposed amendments. Compensation Discussion and Analysis. This new section would be an overview that would provide narrative disclosure of a public company's compensation policies and objectives without resorting to boilerplate. It would precede the more detailed compensation numbers and narrative and would be designed to put the numbers and narrative into perspective for investors. The Compensation Discussion and Analysis section would replace the compensation committee report and the names of the members of the compensation committee would not appear at the end of the disclosure. The performance graph would also be eliminated. Unlike the compensation committee report, and the performance graph, the Compensation Discussion and Analysis section would be soliciting

material, would be filed with the SEC and would be covered by the certifications filed under the Sarbanes-Oxley Act of 2002.

Compensation Tables. A significant focus of compensation disclosure would continue to be detailed tables with numerical compensation information. Under the proposed rules, the compensation tables for executive officers would include the following:

- Summary Compensation Table. The Summary Compensation Table would continue to serve as the principal disclosure for executive compensation and would continue to cover the last three completed fiscal years. Key proposed changes in the summary compensation table include the following:- a new column would report total compensation during each covered fiscal year;- the "named executive officers" covered by the table would include any person who served as principal executive officer 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 completed fiscal year based on total compensation (rather than just salary and bonus as under the current rules) whose total compensation exceeded \$100,000;there would be separate columns for stock awards and option awards which disclose the dollar value for the awards based on SFAS 123(R);- there would be a single column for non-stock incentive plan compensation;- there would be one column for "all other compensation", which replaces the current more-confusing format of separate "other annual compensation" and "all other compensation" columns; and- the "all other compensation" column would include the aggregate increase in actuarial value of pension plans accrued during the year and all earnings on deferred compensation that is not tax-qualified.
- Grants of Performance-Based Awards Table. The first table after the Summary Compensation Table would include information regarding both stock and non-stock performance-based awards during the last completed fiscal year to the named executive officers.
- Grants of All Other Equity Awards Table. The next table would show all equity awards during the last completed fiscal year that are not performance-based (e.g., time vesting options or restricted stock) to the named executive officers. Note that the current disclosure columns in the Option/SAR Grants table with the assumed 5% and 10% annual rates of return would be eliminated because the Summary Compensation Table would include a dollar value for equity awards based on SFAS 123(R).

- Outstanding Equity Awards at Fiscal-Year End Table. This table would disclose outstanding equity awards that have not been exercised (in the case of stock options) or vested (in the case of restricted stock), including values based on the market value of the stock at fiscal-year end.
- Option Exercises and Stock Vested Table. This table would cover the exercise of stock options during the last completed fiscal year and restricted stock vested during the last completed fiscal year, including the value realized based on the market value of the stock and the grant date SFAS 123(R) fair value previously reported on the Summary Compensation Table for comparison purposes.

These tables would 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 would be 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. The SEC also 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.

Post-Employment Compensation. The proposed rules would expand the disclosure of retirement and other post-employment compensation for named executive officers, including the following:

- a new Retirement Plan Potential Annual Payments and Benefits Table would require disclosure of the estimate of retirement benefits to be paid to named executive officers at normal retirement age and, if available, early retirement;
- a new Nonqualified Defined Contribution and Other Deferred Compensation Plans Table covering contributions in the last fiscal year, earnings in the last fiscal year, withdrawals and distributions in the last fiscal year, and balance at fiscal year end; and
- narrative disclosure of other post-employment payments payable to named executive officers, such as contractual or other rights to severance or change of control payments and other benefits.

Director Compensation. For disclosure of director compensation, the SEC has proposed a table that would include total compensation, cash fees, stock and

option awards, non-stock incentive plan compensation and all other compensation. This table would be similar to the Summary Compensation Table for the named executive officers, but would only cover the last completed fiscal year. Footnotes to the table would include details such as outstanding equity awards at fiscal year end. Following the table, narrative disclosure would be required to describe any material factors necessary to an understanding of the table.

Perks

Under the proposed rules, perquisites and personal benefits (perks) would be included in the "all other compensation" column of the Summary Compensation Table for named executive officers, and would also be disclosed in a similar column in the new table for director compensation. Perks are currently required to be disclosed in the "other annual compensation" column of the Summary Compensation Table.

Under the current rules, for each named executive officer, perks can be excluded from the Summary Compensation Table if, in the aggregate for that named executive officer, such perks do not exceed the lesser of \$50,000 or 10% of total annual salary and bonus. In addition, each individual perk must be identified and quantified in a footnote to the table if it exceeds 25% of the total perks for a named executive officer. Under the proposed amendments, the threshold for disclosure of perks would be \$10,000 in the aggregate for perks to a named executive officer. An individual perk would need to be disclosed if valued at the greater of \$25,000 or 10% of total perks.

The SEC's proposing release also contains interpretive guidance on the identification of perks. This guidance can be implemented during the 2006 proxy season under the current rules. Pursuant to the SEC's guidance:

- An item is not a perk if it is integrally and directly related to the performance of an executive officer's duties. The release emphasizes that this is a narrow concept. Examples of items "integrally and directly related to performance" include office space at a company business location (even if larger or otherwise better than other space), a reserved parking space that is closer to business facilities but not otherwise preferential and additional clerical or secretarial service devoted to company matters.
- Otherwise, an item is a perk if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may also 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. Examples of perks under this standard 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 or other living expenses (including relocation assistance), security provided at a principal residence or during personal travel, commuting expenses and discounts on company products not generally available to all employees on a non-discriminatory basis. Examples of items that would not be perks include travel to and from business meetings, other business travel, business entertainment, security during business travel and itemized expense accounts limited to business purposes.

Consistent with the current instructions, the proposed rules provide that perks are to be valued at the aggregate incremental cost to the company rather than the value of the benefit to the executive. Regarding the valuation of the personal use of a company plane, the release specifically notes that the IRS guidelines known as the Standard Industry Fare Level rules are not applicable for SEC purposes.

Proposed Revisions to Form 8-K

In August 2004, the SEC expanded the events triggering the filing of a Form 8-K. This expansion included the disclosure under Item 1.01 of Form 8-K of a company's entry into a material definitive agreement outside of its ordinary course of business, or any material amendment of such an agreement. Based in part on subsequent SEC interpretations of these new Form 8-K requirements, Item 1.01 of amended Form 8-K has resulted in more frequent executive compensation disclosures and accelerated the timing of executive compensation disclosures, including disclosure that previously had been made only on an annual basis in a proxy statement.

In its proposed revisions to Form 8-K, the SEC continues to believe that current disclosure on Form 8-K of a number of types of compensation decisions is material and valuable to investors. The SEC does propose to reorganize and modify such disclosures as follows:

- Amending Item 1.01 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 (generally in the company's next proxy statement).
- 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 last 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.

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 would be extended to certain of these new disclosure requirements under Item 5.02 of Form 8-K.

Beneficial Ownership Disclosure

The SEC proposes to 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 would not apply to 5% shareholders who are not otherwise covered by the rule.

Disclosure of Related Party Transactions

The SEC proposed amendments to streamline and clarify the disclosure of related party transactions pursuant to Item 404 of Regulation S-K. The proposed

amendments would do the following:

- Under Item 404(a), a company would disclose 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 (increased from the current \$60,000 threshold to account for inflation); and- 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) would include any indebtedness transaction and the separate rule on indebtedness in Item 404(c) would be eliminated. The current exception for disclosure of indebtedness transactions with a bank would remain if the loan is not disclosed as nonaccrual, past due, restructured or a potential problem.
- Also excepted from disclosure under Item 404(a) would be executive compensation transactions reported pursuant to Item 402 of Regulation S-K.
- Item 404(b) would require disclosure of the company's policies and procedures for approving related party transactions.
- 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), would be eliminated.

Corporate Governance Disclosure

The proposed rules would 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 would include the following:

- identification of the independent directors of the company and the standards used to determine independence (non-listed companies would need to determine independence for this purpose by selecting the definition of a national securities 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 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;
- consistent with current disclosure requirements for the nominating committee charter, the audit committee charter could 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
- expanded disclosure regarding the compensation committee to be consistent with disclosure currently required regarding the audit committee and the nominating committee, including disclosure of the following:- the scope of authority of the compensation committee;- the extent to which the compensation committee may delegate any authority to other persons;- whether 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);- 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 or director compensation, identifying such consultants, stating whether the consultants were engaged by the compensation committee or any other person, describing the nature and scope of their assignment, the material elements of their instructions and identifying any executive officer contacted by the consultants in carrying out their assignment.

Plain English

The SEC is also proposing that most of the new disclosure under Items 402, 403, 404 and 407 be provided in plain English under the SEC's established plain English guidelines currently applicable to prospectuses. This new requirement would likely drive companies to put the entire proxy statement in plain English.

What to Do Now

Since the proposed rules are not yet effective and are unlikely to be effective until the 2007 proxy season, public companies do not yet need to take steps to implement the rules. In fact, one could argue that the proposed rules may result in less pressure to increase compensation disclosure in 2006. With a comprehensive SEC proposal on the table, most companies will likely decide to



wait until the terms of the final rules are known and there is a level playing field for all public companies.

There are, however, a few things that it would be advisable for public companies to do now:

- Implement the SEC's guidance on perks in 2006. The portion of the proposing release discussing the SEC's views on the definition of perks and the disclosure of perks is effective now. Perk disclosure is a hot button issue for investors, and public companies would be advised to carefully work to identify and fully disclose perks for executive officers and directors.
- Analyze total compensation for named executive officers and consider disclosure in the compensation committee report. The trend toward compensation committee consideration of "tally sheets" reflecting total compensation has been underway for at least a year, and should continue to be a point of emphasis in 2006.
- Give thought to the implementation of the proposed rules, especially how to provide narrative disclosure of compensation policies and objectives in the Compensation Discussion and Analysis section. In making compensation decisions in 2006, consider how such compensation may need to be disclosed in 2007.

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