SEC Releases Final Rules on Disclosure of Executive and Director Compensation

On July 26, 2006, after what proved to be the most fruitful comment period in recent history, the Securities and Exchange Commission (Commission) adopted new rules relating to the disclosure of executive and director compensation and related matters. On August 11, 2006, the Commission published its 436 page adopting release. The rules prescribe in detail a new regime for disclosure of executive and director compensation at a level that has been long awaited by the investing community. The new rules also address disclosures of related person transactions, director independence, corporate governance and related matters.

While the rules are thorough and comprehensive, the Commission has made it clear that it is not in the practice of judging the propriety of a company’s executive compensation program. Rather, its purpose is to provide investors with the tools necessary to make informed decisions. The new rules are drafted with that in mind, and require descriptive “principles-based” disclosure regarding a company’s compensation program.

This advisory is not intended to compare the final rules to those as proposed. Rather, it should serve as a useful tool in preparing the new disclosures, in some instances pointing out significant differences between the new rules and the rules that have been in place since 1992, which we refer to as the “old rules.” Note that this advisory updates and replaces our Executive Compensation and Securities Law Advisory of February 6, 2006, which provided a similar analysis for the proposed rules.

Executive and Director Compensation Disclosures

General Overview

How do the new compensation disclosure rules differ in approach from the old rules?

The historical disclosure regime was based on a relatively narrow rules-based approach, requiring in most areas strict adherence to tabular presentation of prescribed elements of compensation, augmented by footnotes and other explanations where required or deemed useful. In 1992, when the old rules were adopted, this tabular focus was an intentional departure from the then prevalent free-form narrative description of compensation plans and benefits, which more often than not resulted in muddled information that defied comparability analysis. While it has not come full circle with the new rules, the Commission’s current focus is on a more balanced “principles-based” approach to compensation disclosure. This approach melds the now-familiar tabular presentation of specific compensation elements with a requirement for supporting narrative discussion that reaches beyond the mere presentation of

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1 For a summary of the primary differences in the final rules from the proposed rules, please see our July 26, 2006, Executive Compensation and Securities Advisory Special Alert: SEC Adopts in Part and Re-Proposes in Part its Rules relating to Disclosure of Executive and Director Compensation that may be found at: [http://www.alston.com/articles/Special%20Alert%20Rules%20Re%20Disclosure%20of%20Exec%20and%20Dir%20Comp26070557.pdf](http://www.alston.com/articles/Special%20Alert%20Rules%20Re%20Disclosure%20of%20Exec%20and%20Dir%20Comp26070557.pdf)
numbers, to explain the purpose, function and rationale for the different elements comprising the whole executive compensation program. While the old rules had been outpaced by evolving compensation practices that in some instances allowed significant remuneration to fall outside of the disclosure net, the new rules are designed to be nimble – requiring disclosure of all elements of compensation, in whatever form they may take.

**Specifically, what do the new rules require that we have not seen before?**

The most striking addition to the disclosure scheme is the new “Compensation Discussion and Analysis” (CD&A) section, which replaces the traditional compensation committee report and will be in addition to a new and different compensation committee report. In his address to the Business Law Section of the ABA, the Commission’s Director of Corporation Finance John White noted that preparing the CD&A should be viewed as a “new project,” rather than a revision of the old compensation committee report.

The CD&A is not a report of the compensation committee, it will not address the meetings and discussions of the compensation committee, and it is not to be made “over the names” of individual compensation committee members. Rather, the CD&A is a company disclosure that will be deemed “filed” with the Commission as part of the proxy statement and any other filings in which it is included. As such, the CD&A will be subject to the liabilities of Section 18 of the Securities Exchange Act of 1934 (Exchange Act) and covered by the CEO and CFO certifications required to be made under the Sarbanes-Oxley Act.²

The CD&A borrows from the tradition of Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) under Item 303 of Regulation S-K, in that it calls for a frank, accountable, and individualized discussion of information relevant to investors. The CD&A serves as an overview of the company’s overall executive compensation policies and decisions, a discussion of the material principles underlying those policies and decisions and the most important factors relevant to an analysis of those policies and decisions. The CD&A should address (but not repeat) the information contained in the tables and narrative that follows them. However, the CD&A disclosure is not limited to the company’s last fiscal year. Any relevant actions taken after the last fiscal year end should be disclosed, as well as any information from prior years if such information provides context to the discussion. Boiler-plate disclosure is roundly discouraged, and the report must be presented in “plain English.”

The release calls for a customized CD&A and provides examples of issues that would potentially be appropriate for the company to address, not all of which would be relevant for every company. However, the CD&A must address at a minimum:

- the objectives of the company’s compensation program;
- what the compensation program is designed to reward;
- each element of compensation;
- why the company chooses to pay each element;
- how the company determines the amount (and, where applicable, the formula) for each element of compensation; and

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² The rationale, in part, behind the CD&A being filed (rather than furnished) and covered by the CEO and CFO certifications is that it is company disclosure, and the company’s disclosure controls and procedures apply to the preparation of its proxy statement and Form 10-K.
how each compensation element and the company’s decisions regarding that element fit into the company’s overall compensation objectives and affect decisions regarding other elements.

Despite the level of specific discussion required, the instructions to the CD&A make it clear that companies are not required to disclose target levels with respect to quantitative or qualitative performance-related factors, or any factors or criteria involving confidential commercial or business information, the disclosure of which would result in competitive harm to the company. The standard to use in making a determination to omit confidential information is the same as would apply when requesting confidential treatment of information in a registration statement or periodic report, but companies are not required to submit a confidential treatment request in this context. A company may be required to demonstrate to the Commission that omitted information would result in competitive harm if disclosed. Also, the CD&A must discuss the significance of the undisclosed target levels, so that an investor could understand, for example, the relative degree of difficulty in achieving the target levels.

What is the “new and different” Compensation Committee Report?

While the traditional compensation committee report will go by the wayside (replaced in function by the CD&A), a new and different Compensation Committee Report (CCR) will be required, which is similar in format to the Audit Committee Report that appears in annual reports. The CCR requires a statement of whether the compensation committee has reviewed and discussed with management the CD&A and, based on this review and discussion, recommends that the CD&A be included in the company’s proxy statement and annual report on Form 10-K. Unlike the CD&A, the CCR will appear over the names of the committee members and will be “furnished” as opposed to “filed” with the Commission. The CEO and CFO will be permitted to rely upon the CCR in providing their certifications. This permission for reliance on the CCR addresses concerns expressed by some that the CEO and CFO would have been potentially liable for certifying as to the process employed in setting their own compensation, when they by necessity did not participate in that process. In this regard the Commission notes in the release that the focus of the CD&A is not the company’s “process” of determining compensation, but the philosophy and rationale for its compensation practices.

What happened to the performance graph?

Despite the original proposal to eliminate the performance graph, it was retained by popular demand. However, the graph will not be a part of the executive compensation disclosures. Instead, it will appear in the “glossy” annual report to shareholders in response to Item 201 of Regulation S-K, which covers the market price of equity securities, dividends on common stock and certain equity compensation plan information.

Beyond the CD&A, what else is new and different about the new rules?

Following the CD&A, detailed disclosure of executive compensation will be organized into three broad categories:

- **Historical Compensation.** Compensation paid currently or deferred with respect to the last three fiscal years will continue to be reflected in a Summary Compensation Table, but in a revised and reorganized format that includes a new column requiring disclosure of a single figure for total compensation. The main Summary Compensation Table will be followed by a supplemental table providing back-up information for plan-based awards.
• **Equity Holdings.** Holdings of equity-related interests that relate to compensation or are potential sources of future gains, and information regarding recent realization of gains upon the exercise or vesting of equity awards, will be disclosed in two new tables.

• **Retirement and Post-Employment Payments and Benefits.** Retirement benefits, including pension benefits and nonqualified deferred compensation, will be reflected in two new tables. Disclosure as to other potential post-employment benefits, such as those payable in the event of a change in control or constructive termination, will be required in narrative rather than tabular form, although companies are free to add tables if that would improve the clarity of the disclosure.

The new rules require additional narrative disclosure to supplement the information in all of the tables. The following is a more detailed description of these three categories of disclosure.

**Historical Compensation**

**How are the “named executive officers” determined under the new rules?**

Historically, a company’s “named executive officers” included its chief executive officer and the four most highly compensated executive officers excluding the chief executive officer. The new rules add the principal financial officer to the list of “named executive officers,” and the number of additional highly-compensated executive officers is reduced from four to three. Companies should also note that the new rules use the terms “principal” executive officer and “principal” financial officer, rather than “chief” executive officer and “chief” financial officer. Accordingly, the tables refer to the PEO and PFO, rather than CEO and CFO.

The new rules retain the historical requirement to include 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.

**Do the new rules change the method of determining a company’s most highly compensated executive officers?**

Yes. Historically, the determination of the most highly compensated executive officers was based only on total annual salary and bonus for the last fiscal year. The new rules revise this requirement so that the determination will be made on the basis of total compensation for the most recent fiscal year, minus (i) the actuarial present value of accumulated pension plan benefits and (ii) above-market earnings on nonqualified deferred compensation. Note that these two excluded categories of compensation will appear in a separate column in the Summary Compensation Table, making it easy to subtract them from the total compensation. The dollar threshold for disclosure of named executive officers other than the principal executive officer and the principal financial officer will remain at $100,000. For purposes of determining these three other named executive officers, the new rules eliminate the historical exception for compensation that is “not recurring and unlikely to continue” because of the Commission’s concern that such exception was susceptible to manipulation. However, the historical exception for payments attributable to overseas assignments was retained.
What happened to the proposal to require disclosure for up to three highly paid non-executive officers?

The proposed rules would have required narrative disclosure for up to three employees, without naming them, who were not executive officers during the last fiscal year and whose total compensation for the last fiscal year was greater than that of any one or more of the named executive officers. The narrative disclosure for these additional employees would have included the amount of each of such employee’s total compensation for the most recent fiscal year and a description of his or her job position.

This provision was not included in the final rules; however, the Commission is still seeking comment on this proposal and will revisit it at a later time. In the new proposal, the additional disclosure would only apply to large accelerated filers and would only cover employees who have policy-making authority at the registrant or its significant subsidiaries or business units.

What changes have been made to the Summary Compensation Table?

The Summary Compensation Table continues to serve as the principal disclosure vehicle regarding executive compensation. Consistent with historical requirements, the table requires disclosure of compensation for the company’s named executive officers for each of the last three completed fiscal years, whether or not actually paid out. Because the new rules significantly change the mix of information required by the table, however, the Commission is not requiring companies to recalculate entries for prior years. Accordingly, a company’s 2007 proxy statement is only required to include disclosure covering the 2006 fiscal year, and the 2008 proxy statement will include disclosure for 2006 and 2007. In 2009 and following years, three years of historical compensation data will once again be included in the table.

The reconfigured Summary Compensation Table includes the following eight columns:

(i) **Salary.** The salary column is retained substantially in its historical form. It will include salary that was earned in the year, as well as salary that was earned but for which payment was deferred. A new instruction, applicable to the entire Summary Compensation Table, provides that if receipt of any amount of compensation is currently payable but has been deferred for any reason, the amount so deferred must be included in the appropriate column. The amount deferred will also generally be reflected as a contribution in the Nonqualified Deferred Compensation Table, as discussed below.

(ii) **Bonus.** The traditional bonus column is also retained, but will include only bonus amounts that are not performance-based. Annual cash bonuses that are earned based on performance will be reflected in the new Non-Equity Incentive Plan Compensation column, which is a departure from historical practice. Deferrals of bonus amounts are subject to the same disclosure rules described above with respect to salary deferrals.

(iii) **Stock Awards.** The dollar value of equity awards 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 (a/k/a, “full-value” equity awards) must be disclosed in the new Stock Awards column. Stock awards subject to performance-based conditions will also be included in this column to ensure consistent reporting. Valuation of such awards will be based on their grant date “fair value” determined pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS...
Option Awards. The dollar value of stock options, stock appreciation rights, and similar stock-based compensation instruments that have option-like features (a/k/a, “appreciation-type” equity awards) must be disclosed in a new Option Awards column. As with the valuation of stock awards described above, the new rules require disclosure of the grant date “fair value” of the award as determined pursuant to FAS 123R for financial reporting purposes, and the full fair value as of the grant date must be reported in the year of grant, without regard to the amount actually expensed in such year. If an option is modified in a given year, only the incremental increase in fair value resulting from such modification would be shown in the table in the year of the modification. Where the earnings on outstanding stock awards and option awards are not included as part of the grant date fair value calculation, the earnings on such awards are required to be reported in the All Other Compensation column. For example, dividends or dividend equivalents paid on stock awards are typically included in the grant date fair value calculation for the stock award and would not be separately reported as earnings. It is less typical for option-like awards to have dividend equivalent rights or other types of earnings.

Non-Equity Incentive Plan Compensation. A new Non-Equity Incentive Plan Compensation column will show the dollar value, including earnings, of any awards granted under an incentive plan where the relevant performance measure is not based on the price of the company’s equity securities and the award may not be settled by issuance of the company’s equity securities. Awards must be disclosed in this column in the year in which the relevant performance criteria are satisfied and the compensation earned, regardless of whether payment is actually made to the named executive officer in that year.

Change in Pension Value and Nonqualified Deferred Compensation Earnings. Companies must disclose in this column the aggregate change in actuarial present value to the named executive officer of defined benefit and actuarial plans accrued during the year and any above-market or preferential earnings on nonqualified deferred compensation. The company must identify and quantify the full amount of each element in a footnote. Note that this is a departure from the proposed rules that would not have limited the disclosure of earnings on nonqualified deferred compensation to preferential earnings.

All Other Compensation. This column serves as a catch-all for disclosure of all other compensation not required to be disclosed in any other column. It includes, but is not limited to, the following items:

• Perquisites and Other Personal Benefits. The value of perquisites and other personal benefits must be disclosed unless the aggregate amount of such compensation is less than $10,000. Note that this threshold for disclosure is considerably lower than the threshold under the old rules of $50,000 or 10% of salary and bonus. If disclosure of perquisites is required, then each perquisite must be identified in a footnote 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. The new rules do not provide a definition of perquisites or personal benefits.
As discussed below, the adopting release does, however, provide interpretive guidance regarding how to determine whether an item is a perquisite or other personal benefit.

- Additional Items. The All Other Compensation column also includes, but is not limited to, the following items: amounts paid or accrued pursuant to a plan or arrangement in connection with any termination of employment or change in control, annual company contributions to defined contribution plans, dollar value of any insurance premiums paid by the company with respect to life insurance for the benefit of the named executive officer, tax “gross-ups” and other reimbursements, and compensation relating to purchases of securities from the company at a discount.

This column is intended to capture all compensation not included anywhere else in the Summary Compensation Table. It combines the historical Other Annual Compensation and All Other Compensation columns, no longer making a distinction on that basis. Each item of compensation included in the new All Other Compensation column that exceeds $10,000 will need to be separately identified and quantified in a footnote (except that individual perquisites need to be quantified only if they exceed the greater of $25,000 or 10% of total perquisites and other personal benefits).

(viii) Total Compensation. The new Total Compensation column is a hallmark of the new rules. A simple mathematical sum of the other columns in the Summary Compensation Table, it is intended to provide a succinct picture of an executive’s aggregate remuneration for the year and to facilitate comparability analysis from company to company.

What factors should be considered in determining whether an item is a perquisite or other personal benefit?

The adopting release contains welcome guidance regarding the identification of perquisites, an area that has long been shrouded in mystery. The release provides that an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive’s duties, and warns that this standard is to be narrowly construed. Otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees.³ Companies must value perquisites based on the aggregate incremental cost to the company, which reflects the Commission Staff’s guidance in the past, and companies must also disclose in a footnote the methodology for computing such aggregate incremental cost.

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³ Examples of items requiring disclosure as perquisites or personal benefits 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.
Will there be any supplemental tables to the Summary Compensation Table?

Yes. The proposed rules mentioned two supplemental tables the Summary Compensation Table (one focused on equity grants and one focused on performance-based awards), but in the final rules these have been consolidated into one supplemental table called Grant of Plan-Based Awards. Companies must disclose in this table the following information with respect to awards granted in the most recently completed fiscal year: (i) the grant date, and, if such grant date is different from the date on which the board or compensation committee took action to grant such award, the date of such board or committee action; (ii) estimated future payouts at threshold, target and maximum levels under both non-equity and equity incentive plan awards; (iii) the number of shares of stock granted in the fiscal year and the number of securities underlying options that are not required to be disclosed in the preceding columns; and (iv) the per-share exercise price of options granted in the fiscal year, and if such exercise price is less than the closing market price of the stock on the date of grant, the closing market price on the date of grant. The footnotes to the table must contain a description of the material terms of the grants.

Companies should note the rules’ use of the closing market price on the grant date as being the assumed determinant of “fair market value” on the grant date. It is very common for option plans to define fair market value as of the grant date as the closing price of the stock on the last trading day before the grant date or as the average of the high and low trading prices on the grant date. If your plan contains one of these alternate definitions of fair market value (or another one), you should be prepared to footnote the table and explain why you use a convention other than closing market price on the grant date.

What additional narrative disclosure is required?

Under the new rules, companies must provide narrative disclosure of any additional material factors necessary to an investor’s understanding of the information disclosed in the Summary Compensation Table and the Grants of Plan-Based Award Table. This narrative disclosure should focus on and provide context to the quantitative disclosure in the tables. Material factors will vary depending on the facts, but might include descriptions of:

- the material terms in the named executive officers’ employment agreements;
- repricings or other material modifications of any outstanding option or other stock-based award;
- award terms relating to data provided in the Grants of Plan-Based Awards Table, which could include, for example, performance criteria and/or formulas, vesting schedules, 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.

Do the new rules still require the ten-year option repricing table?

No. The information that was formerly provided in the Ten-Year Option Repricing Table will be provided in the narrative disclosure following the Summary Compensation Table. This textual disclosure will provide more information than was contained in the Ten-Year Option Repricing Table, such as the terms of the repricing, extension of exercise periods, change of vesting or forfeiture conditions, change or elimination of applicable performance criteria, change of the bases upon which returns are determined, or any other material modification of an option.
**Equity Holdings**

What disclosure is required with respect to previously-awarded equity compensation?

Under the new rules, two new tables are required to provide investors with an understanding of previously-awarded, outstanding equity compensation, including amounts realized on this type of compensation during the last fiscal year as a result of the vesting or exercise of equity awards.

- **Outstanding Equity Awards at Fiscal Year-End.** This new table will provide certain information relating to outstanding stock options, stock appreciation rights, restricted stock awards and other equity incentive plan awards as of the end of the most recent complete fiscal year. With respect to option-type awards (which would include time-based and performance-based options and stock appreciation rights, for example), the following information must be disclosed: (i) the number of securities underlying unexercised, *exercisable* time-based awards, (ii) the number of securities underlying unexercised, *unexercisable* time-based awards, (iii) the number of securities underlying unexercised, unearned *performance-based* awards, (iv) the exercise price of each such award, and (v) the expiration date of each such award.

  With respect to stock awards (which would include time-based and performance-based restricted stock and restricted stock units awards, for example), the following information must be provided: (i) the number of unvested shares or units of stock, (ii) the market value of unvested shares or units of stock, (iii) the number of unvested, unearned shares, units or other performance-based rights held under equity incentive plans, and (v) the market payout value of unvested, unearned performance-based shares or units of stock held under equity incentive plans. Footnotes will contain certain additional information, including the vesting dates of stock awards and incentive plan awards held at fiscal year-end.

- **Option Exercises and Stock Vesting.** This new table will provide the following information relating to amounts received by each named executive officer upon exercise of option-type awards (which would include time-based and performance-based options and stock appreciation rights, for example) or the vesting of stock or similar instruments (which would include time-based and performance-based restricted stock and restricted stock units awards, for example) during the most recently completed fiscal year: (i) number of shares acquired upon exercise or vesting, and (ii) the value realized upon exercise or vesting.

**Retirement and Post-Employment Payments and Benefits**

What disclosure is required with respect to retirement and post-employment benefits?

The new rules incorporate three main changes regarding disclosure of post-employment compensation: (i) tabular and narrative disclosure of defined benefit pension plans replaces the historical pension plan table, (ii) tabular and narrative disclosure of information regarding nonqualified defined contribution plans and other deferred compensation is a new requirement, and (iii) disclosure requirements regarding compensation arrangements triggered upon a termination of employment or change in control have been revised.

- **Pension Benefits Table.** This new table, which replaces the historical pension plan table, requires disclosure of estimated annual retirement payments under defined benefit plans for each named
executive officer, including the following information: (i) the plan name; (ii) the number of years credited service; (iii) the actuarial present value of accumulated benefit; and (iv) any payments during the last fiscal year. A narrative description will be required of material factors necessary to an understanding of each plan disclosed in the table, such as:

- the material terms and conditions of benefits available under the plan, including the plan’s retirement benefit formula and eligibility standards;
- early retirement arrangements, including identification of any named executive officer who is currently eligible for early retirement;
- 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 reasons for each plan; and
- company policies with regard to such matters as granting extra years of credited service.

• **Nonqualified Deferred Compensation Table.** This new table requires disclosure of the following information related to contributions, earnings and balances under nonqualified defined contribution and other deferred compensation plans, specifically: (i) the dollar value of executive contributions in the last fiscal year; (ii) the dollar value of the company’s contributions in the last fiscal year; (iii) the aggregate earnings in the last fiscal year (not limited to preferential earnings as in the Summary Compensation Table); (iv) aggregate withdrawals/distributions; and (v) aggregate balance at the end of the last fiscal year. Again, a narrative description will be required of material factors necessary to an understanding of each plan disclosed in the table, such as:

- 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 such measures are selected by the named executive officer or the company and the frequency and manner in which such 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.

**What about other potential post-employment payments in the form of resignation, severance, retirement or other termination payments?**

Under the new rules, companies must provide narrative disclosure of the specific aspects of any written or unwritten arrangement that provides 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, including the following:

- the specific circumstances that would trigger payments under the termination or change-in-control arrangements or the provision of other benefits;
Companies must provide quantitative disclosure of estimated termination payments and benefits using the following assumptions: (i) the triggering event took place on the last business day of the company’s last completed fiscal year, and (ii) the price per share of the company’s securities is the closing market price as of that date. In the event that uncertainties exist, the company will be required to make reasonable estimates and disclose material assumptions underlying such estimates. Such disclosure will be considered forward-looking information, as appropriate, that falls within the safe harbor for disclosure of such information.

The calculations can be complex, even using the mandatory year-end assumptions. Companies should reserve plenty of time and resources to complete the calculations in time to be included in the upcoming proxy statement. Companies also should bear in mind that there is no need to disclose broad-based severance programs that are available generally to all employees, and that references can be made to other disclosure, such as the pension and deferred compensation tables, if the relevant information is disclosed there.

**Option Grant Practices**

**How do the new rules respond to the recent publicity about option “backdating” and “spring-loading” and other option grant practices?**

In his introductory remarks to the Commission’s open meeting to adopt the rules, Chairman Cox noted that the new rules intend to provide investors with “a clear and complete picture of how their company uses options to compensate executives.” While the Commission intentionally avoided the use of colloquial terms such as “backdating” or “spring-loading,” the new rules address option grant practices in several ways.

First, the Grants of Plan-Based Awards table that supplements the Summary Compensation Table will show the date of grant of an option, the closing market price on the grant date if it is greater than the exercise price, the methodology for determining the exercise price if it is different than the closing price of the company’s stock on the grant date, and the date the compensation committee or board of directors took action to approve the grant if that date is other than the grant date. These new information requirements should be sufficient to enable investors to readily identify any instance of granting “discounted” options. Moreover, the narrative disclosure that follows the table should be used to explain the rationale for such grants.

Second, the CD&A will require enhanced narrative disclosures about the company’s programs, plans and practices concerning the timing of equity grants in coordination with the release of material non-public
Companies will be called upon to analyze and discuss, as appropriate, material information such as the reasons the company selects particular grant dates for awards or the methods the company uses to select the terms of awards, such as the exercise prices of stock options. The release provides questions to discuss, including, but not limited to, the following:

- Does the company have any program, plan or practice to time option grants to its executives in coordination with the release of material non-public information?
- How does any program, plan or practice to time option grants to executives fit in the context of the company's program, plan or practice, if any, with regard to option grants to employees more generally?
- What was the role of the compensation committee in approving and administering such a program, plan or practice? How did the board or compensation committee take such 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 of a program, plan or practice 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 nonpublic information for the purpose of affecting the value of executive compensation?

It is relevant to note that the Commission does not in the release condemn or condone any particular grant practices. The focus is on full disclosure, so that the effect of a company’s grant practices will be determined by market forces.

**Director Compensation**

**What is new in the area of disclosure of director compensation?**

Under the old rules, a company was required to provide a narrative description of any compensation arrangements with its directors. The new rules require a new Directors Compensation Table, which resembles the Summary Compensation Table but will provide information only with respect to the most recently completed fiscal year.

The new Director Compensation Table will set forth for each director: (i) the dollar amount of any fees earned or paid in cash; (ii) the dollar amount of any stock awards; (iii) the dollar amount of any option awards; (iv) the dollar amount of any non-stock incentive plan compensation; (v) any change in pension value and nonqualified deferred compensation earnings; (vi) the dollar amount of all other compensation received; and (vii) the dollar value of any insurance premiums paid by, or on behalf of, the company for life insurance for the director’s benefit.

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4 The new rules provide that “all other compensation” for directors includes, but is not limited to: all perquisites and other personal benefits if the total is $10,000 or greater; all earnings on nonqualified deferred compensation; all tax reimbursements; annual company contributions or other allocations to vested and unvested defined contribution plans; compensation cost associated with securities purchased from the company at a discount; aggregate annual increase in actuarial value of all defined benefit and actuarial pension plans; amounts paid or accrued pursuant to arrangements in connection with a change in control of the company or the resignation, retirement or other termination of the director; all consulting fees; the annual cost of promises and payments under any 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.
value of the total amount of compensation received. Directors may be listed in a single row of the table if all of their elements and amounts of compensation are identical.

Once again, any material factors necessary to an understanding of the table must be described in the accompanying narrative disclosure. In addition, the aggregate number of equity awards outstanding at fiscal year end must be disclosed in a footnote to the appropriate column of the table.

**Form 8-K**

**How do the new rules change the Form 8-K filing requirements for material agreements relating to executive compensation?**

Since August 2004, Item 1.01 of Form 8-K has required companies to report, within four business days, the entry into a material contract “outside of the ordinary course of business” or an amendment of such a contract that is material to the company. Before the new rules go into effect, these disclosure requirements under Item 1.01 specifically include compensatory plans, contracts and arrangements with any director or named executive officer (regardless of the amount involved), and with any other executive officer unless immaterial in amount or significance.

With its revisions to the Form 8-K rules in August 2004, the Commission intended to increase the “real-time” disclosure of presumptively material events relating to executive compensation. The Commission got more than it bargained for. Interpreting the standards for disclosure conservatively, companies flooded the market with compensation information that arguably was below the intended materiality threshold, which tended to obscure the material information that was duly reported.

In the new rules, the Commission narrows the scope of executive compensation disclosures on Form 8-K with the intent to elicit unquestionably or presumptively material information and to limit “real-time” disclosure of information that falls below that threshold. Specifically, the new rules eliminate the requirement to report pursuant to Item 1.01 the entry into or the material amendment of compensatory plans, contracts and arrangements with directors and executive officers, as well as the requirement to report, pursuant to Item 1.02, the termination of any such contracts.

The filing of this information is largely shifted to Item 5.02 of Form 8-K by expanding that item. Item 5.02 will continue to require disclosure (i) when a new director is elected or resigns or refuses to stand for re-election and (ii) when certain designated officers (principal executive officer, president, principal financial officer, principal accounting officer and principal operating officer) are appointed, retire, resign or are terminated. This list of officers is expanded in the new rules to include any person who was a named executive officer as of the end of the last completed fiscal year. The requirement for disclosure as to other executive officers is eliminated entirely.

In addition to the above information, Item 5.02 will also require a brief description of the terms and conditions of any new or materially amended compensatory plan, contract or arrangement with a named executive officer, and any grant or award made thereunder, unless such grant or award is consistent with previously disclosed plans or arrangements. Revised Item 5.02 also requires disclosure if the salary and bonus of a named executive officer were not calculable as of the time of the last proxy statement, but there is a subsequent payment, grant, award, decision or other occurrence which results in such amounts being calculable in whole or in part.
The Commission reiterates in the release that the “brief description” of material contracts called for in Item 5.02 is intend to be just that, and does not require the level of information needed to comply with Item 402 of Regulation S-K.

Beneficial Ownership Reporting

How do the new rules change the requirements relating to reporting of beneficial ownership?

The new rules amend Item 403(b) of Regulation S-K to require footnote disclosure of the number of shares pledged as security for indebtedness by named executive officers, directors and director nominees. This disclosure provides further transparency into the share ownership of management and how management could be influenced by the risks and contingencies associated with that share ownership.

Disclosure of Related Person Transactions

What are the changes to the disclosure requirements for certain relationships and related transactions?

The Commission adopted significant revisions to Item 404 of Regulation S-K “Certain Relationships and Related Transactions” in order to “streamline and modernize this disclosure requirement, while making it more principles-based.” The changes focus on four sections:

- Revised Item 404(a) contains a general disclosure requirement for related person transactions, including those involving indebtedness;
- Revised Item 404(b) requires disclosure regarding the company’s policies and procedures for the review, approval or ratification of related person transactions;
- Revised Item 404(c) requires disclosure regarding promoters of a company; and
- New Item 407 consolidates existing corporate governance disclosure requirements and requires disclosure regarding the independence of directors.

How has disclosure of related person transactions been revised?

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

It should be noted that the new rules call for disclosure if a company is a “participant” in a transaction, rather than if it is “a party” to the transaction and increases the historical $60,000 threshold for disclosure to $120,000.

How has the materiality standard applicable to related person transactions been modified?

In an effort to clarify the disclosure requirements for certain relationships and related transactions, the Commission adopted a principles-based approach to such disclosure and eliminated certain presumptions regarding materiality. In adopting such approach, the Commission intends to focus the disclosure analysis on
the significance of the information to investors in light of all of the circumstances, including the significance of the interest to the person having the interest, the relationship of the related persons to the transaction, and with each other, and the amount involved in the transaction.

**Are there any changes to disclosure relating to indebtedness of related persons?**

Yes. Although Section 402 of the Sarbanes-Oxley Act prohibits most loans to officers and directors, it does not apply to all related persons (as defined in Item 404) of an issuer. As a result, the Commission integrated paragraph (c) of Item 404 into paragraph (a) of Item 404, and the new rules change some situations in which indebtedness disclosure is required:

- disclosure of indebtedness transactions is now required for significant shareholders who are related persons; and
- disclosure is required of all material indirect interests in indebtedness transactions of related persons, including significant shareholders and immediate family members.

**What key definitions in Item 404 have been changed by the new rules?**

The new rules define the following key terms in order to clarify the broad coverage of the rule: “transaction,” “related person” and “amount involved.”

- “Transaction” includes, but is not limited to, any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships.
- “Related Person” includes any person in any of the following categories at any time during the specified period for which disclosure under Item 404 is required:
  - any director or executive officer of the company;
  - any director nominee if disclosure were provided in a proxy or information statement involving the election of directors; and
  - any immediate family member of any of the foregoing persons.

Also, a security holder known to the registrant to own of record or beneficially more than five percent of any class of the company’s voting securities or any immediate family member of any such person, when a transaction in which such security holder or family member had a direct or indirect material interest occurred or existed will be deemed to be a related person.

The definition of “related person” also requires disclosure of related person transactions involving a company and a person (other than a significant shareholder or immediate family member of such shareholder) that occurred during the last fiscal year, if the person was a “related person” during any part of that year. Disclosure is required if the requisite relationship existed at the time of the transaction, even if the person was no longer a related person at the end of the year.

- “Amount Involved” means the dollar value of the transaction, or series of similar transactions, and includes:
  - in the case of any lease or other transaction providing for periodic payments, 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; 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.

**What disclosure about related person transactions is required?**

Once it is determined that a related person transaction has occurred or will occur, the company must describe the transaction, including:

- the related person’s name and relationship to the company;
- the related person’s interest in the transaction with the company, including the 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 dollar value of the amount involved in the transaction and of the related person’s interest in the transaction; and
- any other information regarding the transaction or the related person that is material to investors in light of the circumstances of the particular transaction.

The new rules eliminate the historical requirement for specific disclosure of the cost of assets purchased or sold by the company if acquired within two years of the transaction, as well as the requirement that disclosure must be provided regarding amounts possibly owed to the company under Section 16(b) of the Exchange Act.

**Are there any new exceptions to related person disclosure?**

Yes. The new rules do not require disclosure of transactions involving compensation to an executive officer or to a director or director nominee if already reported pursuant to Item 402 of Regulation S-K or revised Item 402(1) (compensation of directors), as applicable. Also, disclosure is not required for compensation to an executive officer who is not an immediate family member of a related person where such compensation would have been reported under Item 402 as compensation earned for services to the company if the executive officer was a named executive officer, and such compensation had been approved by the compensation committee of the board of directors.

The new rules do not require disclosure of indebtedness for amounts due from a related person 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.

In addition, the new rules allow reduced disclosure for loans where the lender is a bank, savings and loan association or broker-dealer, and the loans are not disclosed by the institution as non-accrual, past due, restructured or potential problems. In such case, disclosure under Item 404(a) may consist only of a statement that the loans to such persons satisfied the following conditions:

- they were made in the ordinary course of business;
• they were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the bank; and
• they did not involve more than the normal risk of collectibility or present other unfavorable features.

**How do the new rules address the determination of an “indirect” relationship?**

The historical exceptions to Item 404(a) for indirect relationships with entities that engage in transactions with the company have been retained with a minor exception. The new rules omit the portion of the current instruction (Instruction 8.C.) regarding interests arising solely from holding an equity or a creditor interest in a person other than the company that is a party to the transaction, when the transaction is not material to the other person.

**What new disclosures regarding approval of related person transactions will be required?**

The Commission adopted a new requirement for disclosure of the policies and procedures established by a company and its board of directors regarding related person transactions. Specifically, the new rules require a description of the company’s policies and procedures for the review, approval or ratification of any transaction required to be reported under Item 404(a). The description must include the material features of such policies and procedures such as:

• the types of transactions that are covered;
• the standards to be applied;
• the persons or groups of persons on the board of directors or otherwise who are responsible for applying such policies and procedures, which for listed companies would in most cases be the audit committee of the board of directors; and
• whether such policies and procedures are in writing and, if not, how they are evidenced.

The new rules also require identification of any transactions required to be reported under paragraph (a) of Item 404 where the company’s policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed.

**What disclosure is required regarding corporate governance and independence of directors?**

New Item 407 consolidates disclosure requirements regarding director independence and corporate governance under a single disclosure item and updates director independence disclosure requirements to reflect current Exchange Act requirements and current listing standards. Under the old rules, each listed company determines whether its directors and committee members were independent based upon company adopted definitions, which, at a minimum, must comply with the listing standards applicable to the company. The new rules require a company to identify its independent directors (and, in the case of disclosure in proxy or information statements, nominees for director) under the applicable definition of board independence and also any members of the compensation, nominating and audit committee that are not independent under the applicable definition of independence for that board committee.

The new rules require an issuer that has adopted its own definitions of independence for directors and committee members to disclose whether those definitions are posted on the company’s website, or include the definitions as an appendix to the company’s proxy materials at least once every three years or if the policies have been materially amended since the beginning of the company’s last fiscal year.
In addition, the new rules require, for each independent director or director nominee, a description of any transactions, relationships or arrangements (by specific category or type) not disclosed pursuant to paragraph (a) of Item 404 that were considered by the board of directors of the company in determining that the applicable independence standards were met.

In a departure from prior rules, the independence disclosure is required for any person who served as a director of the company during any part of the year for which disclosure must be provided, even if the person no longer serves as a director at the time of filing the registration statement or report or, if the information is in a proxy statement, even if the director’s term of office as a director will not continue after the meeting.

The new rules also revise the disclosure requirements regarding the audit committee and nominating committee to eliminate duplicative committee member independence disclosure and update the required audit committee charter disclosure requirement to be consistent with the more recently adopted nominating committee charter disclosure requirements such that the audit committee charter is no longer required to be delivered to security holders if it is posted on the company’s website.

In addition to the disclosures currently required regarding audit and nominating committees of the board of directors, the new rules require similar disclosure regarding compensation committees. For example, the company must disclose whether the compensation committee’s authority is set forth in a charter or other document, and if so, the company’s website address at which a current copy is available if it is so posted. If the company’s compensation committee charter is not so posted, the company must attach the charter to the proxy statement once every three years (in the same manner that the audit committee charter may be made available).

The company is also required to describe its processes and procedures for the 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 any authority to other persons, specifying what authority may be so delegated and to whom;
- 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 such consultants, stating whether such consultants are engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement and identifying any executive officer within the company the consultants contacted in carrying out their assignment.

Finally, the new rules eliminate an existing proxy disclosure requirement regarding directors that have resigned or declined to stand for re-election because it has been superseded by a disclosure requirement in Form 8-K.
What other rules are affected by the changes to related person transaction disclosure?

The changes to Item 404 require conforming amendments to other rules that refer specifically to Item 404, including Regulation Blackout Trading Restriction (BTR), and to the definition of a Non-Employee Director in Rule 16b-3. The conforming amendment to the Non-Employee Director definition continues to permit consulting and similar arrangements subject to limits measured by reference to the Item 404(a) disclosure requirements and also deletes the provision referring to business relationships subject to disclosure under former Item 404(b). It should be noted that because the disclosure threshold of Item 404(a) has been raised from $60,000 to $120,000 under Item 404(a), the effect in some cases may be to permit previously ineligible directors to be Non-Employee Directors, and where Item 404(a) may require disclosure of business relationships not subject to disclosure under current Item 404(b), some current Non-Employee Directors may become ineligible. To avoid unpleasant surprises at award grant time, every company should review the eligibility of its compensation committee members as Section 16 “Non-Employee Directors” under these new standards.

Do the new rules require executive compensation and related person disclosure to be provided in plain English?

Yes, the Commission is serious about having companies communicate with their shareholders in a manner that is straightforward and understandable to the average investor. The new rules require that most of the disclosure required by Items 402, 403, 404 and 407 regarding executive and director compensation, related person transactions, beneficial ownership and corporate governance disclosures be provided using the “plain English” principles currently required for prospectuses.

When are the new rules effective?

- For Forms 8-K, compliance will be required for triggering events that occur 60 days or more after publication of the final rules in the Federal Register.
- For Forms 10-K and 10-KSB, compliance will be required for fiscal years ending on or after December 15, 2006.
- For proxy and information statements covering registrants other than registered investment companies, compliance will be required for any new proxy or information statements filed 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.
- For Securities Act registration statements covering registrants other than registered investment companies and Exchange Act registration statements (including pre-effective and post-effective amendments, as applicable), compliance will be required for registration statements that are filed with the Commission on or after December 15, 2006, which are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.
- For initial registration statements and post-effective amendments that are annual updates to effective registration statements that are filed on Forms N-1A, N-2 and N-3 (except those filed by business development companies), compliance will be required for registration statements and post-effective amendments that are filed with the Commission on or after December 15, 2006.
• For proxy and information statements covering registered investment companies, compliance will be required for any new proxy or information statement filed on or after December 15, 2006.

Conclusion

In many ways the new rules provide a positive opportunity for issuers and compensation committees to review and reevaluate their compensation philosophy and practices. The new CD&A is intended to be much more robust than the traditional compensation committee report and requires companies to address even the most basic elements of their compensation structure (e.g., “why do we offer what we do, when do we provide it, and how do all the elements work together as a whole?”). A natural result of this review is to ask whether the company’s present practices are working as intended or whether other alternatives would more effectively address the company’s compensation objectives.

Regardless of the outcome of this evaluation, it is clear that the new rules will require substantial lead time to prepare for next year’s proxy statement. Now is the time to assemble the team that will lead the project, as much work will be required to coordinate, assemble, and analyze the required information. We recommend that compensation committees be given a draft of the new disclosures well before year-end to allow ample time for review and revision. Drafting the new CD&A will be a new undertaking. Expect the disclosures to undergo a number of rounds of input from the committee and management to ensure that it covers all of the new information in full, frank, and plain-spoken discourse.

Alston & Bird LLP attorneys will be glad to assist you as you work through the new rules.
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