

February 2006

SEC Proposes Overhaul of Executive Compensation and Related Party Transaction Rules

On January 27, 2006, the SEC issued the much anticipated proposed revisions to its rules governing disclosure of executive compensation, director compensation, related party transactions, director independence and related corporate governance matters and current reporting regarding compensation arrangements. The proposed rules are intended to provide investors with a clearer and more complete picture of a company's executive compensation arrangements. Consistent with the SEC's recent pronouncements in this area, the SEC continues to confirm that a company must disclose all elements of compensation.

IMPORTANT! Although the proposed rules will not be effective for the 2006 proxy season, they are likely to be effective (in some form) for the 2007 proxy season which would require disclosure of 2006 executive compensation. Issuers should immediately review the proposed rules, evaluate their executive compensation arrangements and consider the effects of the disclosure of executive compensation being paid or provided during 2006. Some issuers may wish to change their executive compensation arrangements based upon these effects. In addition, the SEC did offer some interpretative guidance with respect to the determination of perquisites and personal benefits that are applicable to this year's proxy materials.

Executive Summary

The principal changes proposed by the SEC include the following:

- ♦ Modification of the group comprising "named executive officers";
- ♦ A new Compensation Discussion and Analysis section (analogous to the MD&A);
- ♦ A revised and expanded Summary Compensation Table, including a new "total compensation" column;
- ♦ Additional supplemental compensation tables (resulting in as many as nine tables) and related narrative discussions;
- ♦ Tabular disclosure of director compensation;
- ♦ Changes regarding related party transactions including disclosure requirements regarding policies and procedures for approval;
- ♦ Consolidation and other modifications of director independence and other corporate governance related disclosures;
- ♦ Modification of the disclosure requirements in Form 8-K regarding employment compensation arrangements;
- ♦ Disclosure of shares pledged as collateral and directors' qualifying shares; and
- ♦ Extension of plain English disclosure requirements.

Officers Covered

The proposed rules modify the group that comprises the "named executive officers" for whom disclosure is required. Under the current rules, the "named executive officers" are the chief executive officer and the four most highly compensated executive officers other than the chief executive officer. The proposed rules would specifically require disclosure with respect to the principal financial officer, in addition to the principal executive officer, and the three most highly compensated executive officers other than the principal executive officer and principal financial officer. The determination of this group would be made as of the end of the issuer's last fiscal year, but if disclosure would have applied to an individual if he or she had remained employed through the end of the year, then disclosure would apply to that individual as well. The proposed rules continue to apply the \$100,000 threshold to determine whether an individual is one of the most highly compensated executives, but the proposed rules expand this amount from salary and bonus to total compensation.

Compensation Discussion and Analysis

Under the proposed rules, a company must provide a new Compensation Discussion and Analysis (CD&A) section. The CD&A and the narrative discussion following the compensa-

tion tables would replace the Compensation Committee Report and the Performance Graph. Unlike the Compensation Committee Report, the CD&A would be deemed “filed” with the SEC and therefore subject to the disclosure and liability provisions of the Securities Act of 1933, as amended (Securities Act), and the Securities Exchange Act of 1934, as amended (Exchange Act), including the CEO and CFO certification requirements.

The CD&A, according to the SEC, would be analogous to a company’s MD&A and would discuss the separate elements of executive compensation as well as executive compensation as a whole. The SEC contemplates that the CD&A would provide a general overview of the material factors underlying the compensation policies and decisions reflected in the compensation tables by addressing the following issues:

- ◆ what are the objectives of the company’s compensation programs?
- ◆ what is the compensation program designed to reward and not reward?
- ◆ what is each element of compensation?
- ◆ why does the company choose to pay each element of compensation?
- ◆ how does the company determine the amount (or formula) for each element?
- ◆ how does each element and the company’s decisions regarding that element fit into the company’s overall compensation objectives and affect decisions regarding other elements?

The CD&A also would require a discussion of post-termination as well as current employment compensation arrangements. Although the SEC recognizes that the CD&A will vary from company to company, the SEC identified 12 examples of issues that might be appropriate for a company to address. In general, the SEC-identified examples include information regarding a company’s policies that deal with the form and type of compensation, the basis for determining the type and granting of various awards, specific items of both corporate and individual performance measures, the impact of prior compensation, taxes, security ownership guidelines and benchmarking, and the role of executive officers in the compensation process. In addition, to the extent material differences in compensation policies and decisions for individual named executive officers exist, those differences should be discussed. As under current rules, confidential information and performance targets would continue to be excluded if disclosure would have an adverse competitive effect on the company.

Summary Compensation Table

The Summary Compensation Table would continue to serve as the principal disclosure vehicle for executive compensation. This table would disclose the compensation of each named executive officer (identified above) for the last three fiscal years. This table would include nine separate columns quantifying each element of the executive’s compensation including the following:

- ◆ **Total compensation** (column (c)) which would aggregate the amounts set forth in each of the other columns. The SEC intends this column to provide investors with a single, accurate, aggregate amount of compensation that is comparable across years and companies.
- ◆ **Salary and bonus** (columns (d) and (e)) including deferred amounts without regard to whether the executive affirmatively elected to defer the compensation. (Under current rules, deferred amounts must only be disclosed if the executive affirmatively elected the deferral.)
- ◆ **Grant date fair value of stock awards** (columns (f) and (g)). Important to note here is that the Summary Compensation Table would no longer include the number of shares, but rather the full FAS 123R value of such shares on the date of grant and not the compensation cost spread over the period of service.
- ◆ **Other incentive awards** (column (h)) would disclose the dollar value of amounts earned during the fiscal year under arrangements where the performance measure is not based on the stock price of the issuer and the award may not be settled in the issuer’s stock. Important to note here is that amounts are disclosed only when the executive has satisfied the relevant performance criteria and the compensation is earned. (Unearned incentive awards would be disclosed under the Grants of Performance-Based Awards table described below.)
- ◆ **All other compensation** (column (i)) would include all other amounts not otherwise captured in columns (c) through (h). The SEC intends this column to be a “catch all” number. It would include earnings on deferred compensation without regard to whether such amounts are above or below market. This column also would include the aggregate increase in the executive’s accrued benefit under any defined benefit plan sponsored by the issuer, including both qualified and nonqualified plans. (The Retirement Plan Potential Annual Payments and Benefits table, described below, would include additional detail and information regarding these plans and the benefits they would provide to the named executive officers.) The proposed rules also specify that this column would include perquisites and other benefits if the aggregate amount equals at least \$10,000. If the value of any perquisite is more than the greater of \$25,000 or 10% of total perquisites and other personal benefits, then the value of the individual perquisite must be separately disclosed and identified. The interpretive guidance further clarifies that an item is a perquisite if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company. The interpretive guidance also provides that an item is not a perquisite if it is (i) “integrally and directly related” to job performance or (ii) generally available on a non-discriminatory basis to all employees. Given the breadth of the “all other compensation” column, the final rules may include these amounts in an entirely separate table.

Grants of Performance-Based Awards

Supplementing the Summary Annual Compensation Table explained above would be the Grants of Performance-Based Awards table intended to provide greater detail regarding performance-based awards included in columns (f), (g) and (h) of the Summary Compensation Table. The proposed rules consider an award “performance based” if the award is subject to either a performance condition or market condition as defined in FAS 123R. This table would disclose the number of stock-based shares/units/rights, the number of securities underlying any options awarded, the number non-stock units, the value of any consideration paid for the shares/units, the grant date of the awards, any earn-out period, option expiration date, and the estimated future payouts, including minimum, target and maximum payouts.

Grants of All Other Equity Awards

A second table intended to supplement the Summary Compensation Table would be the Grants of All Other Equity Awards table. Here an issuer would disclose equity-based compensation awards that are not performance based. This table would disclose the number of securities underlying any option, exercise or base price, expiration date, number of shares or units granted, and vesting and grant dates.

Narrative Disclosure to Summary Compensation

The proposed rules would require a narrative disclosure that would follow the three tables mentioned above which would describe any additional material factors that are necessary to understand the tables. The proposed rules provide that material factors might include the following:

- ♦ employment agreement terms;
- ♦ repricing or other material modifications to equity awards;
- ♦ extensions of option exercise periods;
- ♦ changes in vesting or forfeiture conditions;
- ♦ changes to performance criteria;
- ♦ changes to the bases upon which returns are calculated;
- ♦ a general description of the formula for performance-based awards;
- ♦ vesting schedules;
- ♦ whether dividends are paid on equity awards and the applicable rate;
- ♦ any material waiver or modification of any performance target, goal or condition to payment under any incentive plan;
- ♦ material assumptions underlying the value assigned to the increase in the executive’s accrued benefit under the issuer’s defined benefit plans; and

- ♦ provisions for determining earnings on deferred compensation.

Outstanding Equity Awards at Fiscal Year-End

The proposed rules also would require a table that identifies all outstanding equity awards that have been granted but which remain unvested or unexercised at the end of the last fiscal year. This table would identify the number of shares underlying the unvested or unexercised awards, the value of any “in-the-money” options, the number of unvested shares, the market value of the unvested shares, the number of unvested shares or units in the issuer’s incentive plans and the market or payout value of the unvested shares in the incentive plan. This table would include a footnote identifying the expiration date of options and similar instruments separately identifying which are exercisable and which are not and the vesting dates of awards held at the end of the fiscal year.

Option Exercises and Stock Vesting

The proposed rules would include a fifth table identifying the amounts the executive received upon exercise of any option or similar instrument or upon vesting of stock or other equity during the most recent fiscal year. This table would identify the number of shares acquired upon exercise or vesting, the value realized, and the grant date fair value previously reported in columns (f) or (g), as applicable, to the Summary Compensation Table, as explained above.

Retirement Plan Potential Annual Payments and Benefits

To provide greater disclosure of post-employment compensation, the proposed rules would replace the current pension plan table, alternative plan disclosure and other pension narratives with a detailed table disclosing an executive’s defined benefit plan accruals. A separate line would be required for each plan in which the executive participates and the columns would identify the number of years of credited service, the plan’s normal retirement age, the estimated normal retirement benefit based upon the current form of distribution and the executive’s current compensation, any early retirement age and the estimated early retirement benefit. If the executive’s credited service differs from his actual service, the proposed rules would require a footnote identifying the difference. This table would be followed by a separate narrative providing significant detail regarding the underlying defined benefit plan, including the retirement benefit formula, eligibility criteria, early retirement benefit provisions, if a lump sum option is available, the value of the accrued lump sum and the method and assumptions that the issuer used to calculate the value, each element of the plan’s definition of compensation, the purpose of each plan if an executive participates in more than one plan and any policy the issuer follows in granting additional years of credited service.

Nonqualified Defined Contribution and Other Deferred Compensation Plans

The proposed rules would provide further disclosure regarding an executive's post-employment compensation in a table that would disclose the nonqualified defined contribution plans and other deferred compensation arrangements in which the executive participates. This table would disclose the executive's deferrals, employer contributions, aggregate earnings, aggregate withdrawals and distributions, all with respect to the last fiscal year. The final column would disclose the executive's aggregate balance. A footnote to this table would specify whether amounts in this table were also disclosed as compensation in the Summary Compensation Table. A narrative is proposed to follow this table which would provide supplementary material information including the type of compensation an executive may defer under the arrangement, any limits on an executive's ability to defer compensation, interest and earnings, and the arrangement's distribution provisions.

Other Potential Post-Employment Payments

The proposed rules would include a narrative explanation of any arrangement that provides for payments upon the executive's termination or a change in control of the issuer. These issues would be disclosed in a narrative only (no table) which would describe the specific circumstances that trigger payment, estimates of the amount payable upon the trigger, the form and duration of the payment, by whom the payments would be made, any factors used to determine the pay and benefit levels, and any condition or obligation that may apply to the payments (such as a restrictive covenant). The proposed rules would require an issuer to estimate payments to the extent they cannot be fully quantified and to identify the assumptions the issuer used in estimating the value.

Compensation of Directors

The proposed rules also would require a compensation table and accompanying narrative disclosing director compensation for the issuer's last fiscal year. The table would disclose total compensation, fees, value of stock awards, value of option awards, value of non-stock incentive compensation, and all other compensation similar to the "catch all" column in the Summary Compensation Table described above but specifically including the compensation cost for any equity the director purchased at a discount (unless either all security holders or all salaried employees may purchase the security at the same discount), consulting fees, awards under any director legacy or charitable awards program, and the value of any insurance premiums paid on behalf of the director. Any outstanding equity awards would be required to be disclosed in a footnote to this table.

Related Party Transactions

The proposed rules provide a broad principle for disclosures of related party transactions. Specifically, a company would be required to disclose any transaction since the beginning of the company's last fiscal year or any currently proposed transaction in which the company is a "participant" (as

opposed to the current requirement that a company is a party to the transaction) in which any related person has a direct or indirect material interest and the amount involved exceeds \$120,000 (up from the current \$60,000 threshold). The materiality of any interest would continue to be determined on the basis of the significance of the information to investors in light of all the circumstances and the significance of the interest to the person having the interest. In that regard, the relationship of the related persons to the transaction, and with each other, and the amount involved in the transaction would be among the factors to be considered in determining the materiality of the information to investors. According to the SEC, the related party transaction rule calls for, and would continue to call for, a materiality analysis of transactions above the threshold in order to determine if the related person has a direct or indirect material interest. The SEC reaffirmed that the proposed \$120,000 threshold would not be a bright line materiality standard but is merely a factor to be considered in the materiality analysis.

The proposed rules also would eliminate the current distinction between indebtedness and other related party transactions, and a company would be required to disclose indebtedness transactions with regard to all related persons, including significant shareholders (shareholders known by the company to beneficially own more than five percent of any class of the company's voting securities). The proposed rules would require the disclosure of all material indirect interests in indebtedness transactions of related persons, including significant shareholders and immediate family members.

The proposed rules also provide certain exceptions to the disclosure requirements for related party transactions that the SEC believes are consistent with its principles-based approach. Most importantly, disclosure of compensation to an executive officer would not be required under the related party transaction rules if (i) the compensation is reported pursuant to Item 402 of Regulation S-K, or (ii) the executive officer is not an immediate family member of a related person and 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 as such by the compensation committee (or group of independent directors performing a similar function) of the company. Accordingly, a company may want to require, as part of its compensation practices, the compensation committee to approve every material element of compensation of an executive officer who is not a named executive officer to avoid having to disclose their compensation under the related party transaction rules.

If the transaction falls within the scope of the proposed rules, a company would be required to describe the transaction, including the person's relationship to the company, the person's interest in the transaction with the company, including the related person's position or relationship with an entity that is a party to or has an interest in the transaction and the dollar value of the amount involved in the transaction and of the related person's interest in the transaction.

The proposed rules also would require a description of the company's policies and procedures with respect to the review, approval or ratification of related party transactions that would be reportable. While the material features of such policies and procedures would vary depending on the particular circumstances, examples of such features may include, among other things:

- ♦ the types of transactions that are covered by such policies and procedures, and the standards to be applied pursuant to such policies and procedures;
- ♦ the persons or groups of persons on the board of directors who are responsible for applying such policies and procedures; and
- ♦ whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.

The proposal also would require the identification of any reportable related party transactions where the company's policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed.

Director Independence and Corporate Governance

The proposed rules would consolidate the disclosure requirements regarding director independence and related corporate governance disclosure requirements under a single disclosure item (new Item 407 of Regulation S-K) and update the disclosure requirements regarding director independence to reflect current requirements and current listing standards. Today, each listed company determines whether its directors and committee members are independent based on definitions that it adopts which, at a minimum, are required to comply with the listing standards applicable to the company.

As proposed, the new rules would require (i) disclosure of whether each director and director nominee is independent, (ii) a description of any relationships not otherwise disclosed that were considered when determining whether each director and director nominee is independent, and (iii) disclosure of any audit, nominating and compensation committee members who are not independent. Under the proposed rules, a company would be required to use the definition for independence of directors (and for committee members) that is in compliance with the applicable listing standards. If a company uses its own definition, then the company must disclose its definitions on its website or as an appendix to its proxy statement.

In addition to the disclosures currently required regarding audit and nominating committees, the proposed rules would require similar disclosure regarding compensation committees relating to the makeup and composition of the committee. A company also would be required to describe its processes and procedures for the consideration and determination of executive and director compensation, including:

- ♦ the scope of authority of the compensation committee;
- ♦ the extent to which the compensation committee may delegate any authority to other persons, specifying what authority may be delegated and to whom;
- ♦ whether the compensation committee's authority is set forth in a charter, and if so, providing the company's website address or 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 and director compensation, identifying such consultants, stating whether such consultants are engaged directly by the compensation committee, 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.

Proposed Changes to Form 8-K

The staff of the SEC has acknowledged that much of the information that has been filed under Item 1.01 of Form 8-K falls below the "unquestionably or presumptively material" standard associated with the expanded Form 8-K disclosure items. To alleviate these issues, the SEC has proposed changes to Form 8-K that would consolidate all Form 8-K disclosure regarding employment arrangements under a single item.

Under the proposing release, Item 1.01 would be amended to eliminate employment compensation arrangements and to cover these compensation arrangements under a modified and broader Item 5.02. This change also will apply to disclosure of terminations of material definitive agreements under Item 1.02 of Form 8-K, which references the definition of "material definitive agreement" in Item 1.01 of Form 8-K.

The proposed changes would expand the information regarding retirement, resignation or termination to include all persons falling within the definition of named executive officers for the company's previous fiscal year, in addition to those specified officers enumerated under current Item 5.02. In addition, the proposed changes would expand the disclosure items covered under Item 5.02 beyond employment agreements to require a brief description of any material plan, contract or arrangement to which a covered officer or director is a party or in which he or she participates that is entered into or materially amended in connection with any of the triggering events specified in Item 5.02, or any grant or award to any such covered person, or modification thereto, under any such plan, contract or arrangement in connection with any such event.

With respect to specified officers, or persons falling within the definition of named executive officer for the company's previous fiscal year, the proposed changes would expand the disclosure items to include a brief description of any material new compensatory plan, contract or arrangement, or new grant or award thereunder (whether or not written), and any material amendment to any compensatory plan, contract or arrangement (or any modification to a grant or award thereunder), whether or not such occurrence is in connection with a triggering event specified in Item 5.02. Grants or awards or modifications thereto will not be required to be disclosed if they are consistent with the terms of previously disclosed plans or arrangements and they are disclosed the next time the company is required to provide new disclosure under Item 402 of Regulation S-K. Finally, the proposed changes would add a requirement for disclosure of salary and bonus for the most recent fiscal year that was not available at the latest practicable date in connection with disclosure under Item 402 of Regulation S-K.

Beneficial Ownership

The beneficial ownership requirements would be amended to require the footnote disclosure of shares pledged as collateral by named executive officers, directors and director nominees, as well as directors' qualifying shares.

Plain English

Finally, the proposed rules would extend the plain English requirements currently applicable to portions of registration statements filed under the Securities Act to periodic reports and current reports filed under the Exchange Act and information in proxy or information statements incorporated by reference into those reports.

Transition

The proposing release provides that adoption and the proposed new rules and amendments would become effective following publication of the adopting release in the Federal Register as follows:

- ◆ Forms 10-K and 10-KSB, for fiscal years ending 60 days or more after publication;
- ◆ Forms 8-K, for triggering events that occur 60 days or more after publication;
- ◆ for Securities Act and Investment Company Act registration statements (including post-effective amendments) and Exchange Act registration statements that become effective 120 days or more after publication; and
- ◆ for proxy statements that are filed 90 days or more after publication.

In addition, the SEC explicitly noted that it will not require companies to "restate" compensation or related party transaction disclosure for prior fiscal years. This would result in phased-in implementation of the proposed Summary Compensation Table amendments and proposed Item 404(a) disclosure over a three-year period for Regulation S-K companies, and a two-year period for Regulation S-B companies.

If you have any questions or require further guidance with respect to the new executive compensation disclosure requirements or any of the SEC's reporting requirements, please contact your Seyfarth Shaw attorney or any attorney on our website at www.seyfarth.com.

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ATLANTA

One Peachtree Pointe
1545 Peachtree Street, N.E., Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON

Two Seaport Lane, Suite 300
Boston, Massachusetts 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO

55 East Monroe Street, Suite 4200
Chicago, Illinois 60603-5803
312-346-8000
312-269-8869 fax

HOUSTON

700 Louisiana Street, Suite 3700
Houston, Texas 77002-2797
713-225-2300
713-225-2340 fax

LOS ANGELES

One Century Plaza
2029 Century Park East, Suite 3300
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK

1270 Avenue of the Americas, Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO

400 Capitol Mall, Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO

560 Mission Street, Suite 3100
San Francisco, California 94105
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.

815 Connecticut Avenue, N.W., Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS

Boulevard du Souverain 280
1160 Brussels, Belgium
(32)(2)647.60.25
(32)(2)640.70.71 fax