

They Are Here—New Executive and Director Compensation and Other Related Party Disclosure Rules

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On August 11, 2006, the Securities and Exchange Commission (SEC) released its final rules regarding disclosure of executive and director compensation required in public company proxy statements, annual reports and registration statements. At the same time, the SEC released new rules regarding the disclosure of new or modified executive compensation arrangements under the Form 8-K reporting requirements, as well as related party transactions, director independence and related corporate governance matters.¹

Overview of the New Rules

The new rules substantially overhaul and expand the current executive and director compensation disclosure rules. The objectives of the new rules are to clarify a company's compensation disclosure and to make compensation practices more transparent to investors. These objectives are achieved through enhanced narrative and tabular disclosure. In particular, more fulsome narrative disclosure of a company's compensation policies and practices is required through a Compensation Discussion and Analysis (CD&A) section. Tabular disclosure is also enhanced through expansion of the Summary Compensation Table (SCT) and the addition of tables covering eq-

uity related holdings, retirement and other post-employment compensation and directors' compensation.

The new executive compensation rules will be effective for the 2007 proxy season. Accordingly, we recommend that companies begin the process of reviewing their compensation practices and policies now in order to be ready to comply with the new enhanced disclosure rules. For example, in its release of the final rules, the SEC emphasized that the use of boilerplate narrative for the CD&A section will not comply. As a result, significant review of compensation practices may be needed to satisfy this and the other new disclosure requirements.

The final rules divide compensation disclosure into four new sections concerning executive compensation and one new section concerning directors' compensation:

- Executive compensation policies and practices narrative disclosure, comprised of two sections, the CD&A and the Compensation Committee Report
- Total compensation for the three most recent fiscal years for executive officers, presented through tabular disclosure under the SCT
- Equity related holdings of executive officers presented in two tables: one for equity related holdings held at the end of the fiscal year and

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their value, and the other detailing the value each executive officer received during the fiscal year as a result of option exercises and restricted stock vesting

- Retirement and other post-employment benefits applicable to executive officers, including a narrative discussion of potential severance and change in control agreements. In addition, two new tables are required, detailing the current actuarial value of pension benefits and the value of deferred compensation benefits
- Directors' compensation disclosure, including a new Director Compensation Table similar to the SCT

Compensation Discussion and Analysis

The narrative section of the new compensation disclosure begins with the new Compensation Discussion & Analysis section, which provides a general overview of a company's compensation policies, programs and practices for named executive officers (NEOs).² The CD&A is principles rather than rules based and should identify the principles underlying the company's executive compensation policies and decisions. It must be comprehensive in scope and should provide perspective on the compensation policies underlying the numerical disclosure and other information contained in the tabular disclosure, and it should not just repeat such disclosure.

Elements of Compensation—The CD&A must discuss the material elements of the company's executive compensation programs and how the compensation is determined and paid. In particular, the CD&A must address the following six items:³

- What are the objectives of the company's compensation programs?
- What is each compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?

- How does the company determine the amount (and, where applicable, the formula) paid 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 most significant challenge when drafting the CD&A will likely be articulating the rationale underlying the components of the executive compensation package. As a helpful start, the SEC has provided 15 examples of topics that would be appropriate for inclusion in the CD&A. However, the SEC has stressed that a discussion of each topic is not required. Rather, a discussion of the items listed in the examples should be included in the CD&A only to the extent applicable in light of a company's particular facts and circumstances. Furthermore, companies should describe all compensation policies which apply, even if a particular policy is not covered in the SEC examples. The SEC examples are as follows:⁴

- Policies for allocating between long-term and currently paid compensation,
- Policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation,
- For long-term compensation, the basis for allocating compensation to each different form of award (such as the relationship of the award to the achievement of the company's long-term goals, management's exposure to downside equity performance risk, correlation between cost to the company and expected benefits to the company),
- How the determination is made as to when awards are granted, including awards of equity-based compensation such as options?
- What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions?
- How specific forms of compensation are structured and implemented to reflect these items of

the company's performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goals or to reduce or increase the size of any award or payout), identifying any particular exercise of discretion and stating whether it applied only to one or more specified NEOs or to all compensation subject to the relevant performance goals

- How specific forms of compensation are structured and implemented to reflect the NEO's individual performance and contribution to the company's performance?
- Company policies and decisions regarding the adjustment or recovery of awards or payments if the relevant company performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment,
- The factors considered in decisions to materially increase or materially decrease compensation,
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits)?
- With respect to any severance or change in control arrangement, the basis for selecting particular events as triggering payment (e.g., the rationale for providing a single trigger for payment in the event of a change in control),
- The impact of the accounting and tax treatments of the particular form of compensation (including but not limited to tax consequences under Section 162(m) of the Internal Revenue Code and other tax consequences to the NEOs and to the company),
- The company's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership) and any company policies regarding hedging the economic risk of such ownership,

- Whether the company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies),
- The role of executive officers in determining executive compensation.

Option Practices—In addition to the previous suggested topics, companies are required to discuss the reasons for selecting particular grant dates for option awards and the methodology for selecting exercise prices and other terms of options. In particular, if option exercise prices are not based on the stock's closing trading price on the grant date, then the method for determining the price must be disclosed.

Companies must also disclose and discuss any policies or practices regarding the timing of stock option grants with the release of material information. If a company has such a policy or practice, then it should also disclose the board or compensation committee's role in approving and administering such policy or practice and whether the compensation committee delegated any aspect of the actual administration of such policy or practice, as well as management's role in option timing practices. If a company has not previously disclosed a policy or practice of timing options and since the beginning of the past fiscal year a decision has been made to time option grants, then a description of such a decision is required.

Performance Compensation and Disclosure of Confidential Information—With respect to performance based compensation, the CD&A will require companies to discuss the performance factors considered in setting executives' pay. However, companies may omit specific performance targets involving confidential trade secrets or confidential commercial or other financial information if the disclosure of such targets would result in competitive harm.⁵ If a company omits specific quantitative or qualitative targets, then it must discuss how difficult it will be for the executive to achieve the undisclosed target levels. The CD&A is subject to review by the SEC. Upon review, the SEC may require a company to demonstrate that the exclusion of performance targets was warranted and/or disclose the information if the SEC or its staff determines that the standards

for exclusion are not met. The same standards for requesting confidential treatment of trade secrets and information that is otherwise required to be disclosed in documents filed with the SEC will apply in determining whether a company is required to disclose performance targets in the CD&A. However, no request for confidential treatment is required. Accordingly, if information has already been publicly disclosed, it may not be omitted.

Disclosure in the CD&A of target levels that apply a non-GAAP financial measure will not be subject to the SEC's other general rules regarding disclosure of non-GAAP financial measures. However, a company must disclose how the target level is calculated from the audited financial statements.

Periods Covered by Disclosure—The CD&A is required to discuss all material aspects of compensation for the last fiscal year and may also include discussion of future policies and programs, if relevant. Unlike the current Compensation Committee Report, the CD&A should include any actions taken after the end of the fiscal year and prior to the filing of the proxy, if relevant. A discussion of prior fiscal years may also be necessary in order to give context to the disclosure provided.

Differences in Applicable Policies—If the decisions or policies applicable for any NEO differ from those applicable to other NEOs, the CD&A must discuss such differences, as well as the reasoning behind such differences.

Legal Status of CD&A—The CD&A will be deemed to be “filed” with the SEC and therefore subject to the general disclosure and liability provisions of the Securities Act and the Exchange Act. Because the CD&A will be incorporated by reference or in some cases directly included in the Form 10-K, the CD&A will be subject to the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) certifications required by the Sarbanes-Oxley Act. In the final release, the SEC clarified that the CD&A is a company disclosure and not a disclosure of the compensation committee. Accordingly, the CEO and CFO are not being called upon to certify any deliberations of the compensation committee. In certifying the CD&A, the CEO and CFO are permitted to rely upon the “furnished” Compensation Committee Report which

is further discussed.

Compensation Committee Report

The final rules retain the requirement for a Compensation Committee Report to be presented over the names of the individual members of the compensation committee, or if there is no such committee, the entire board. However, the Compensation Committee Report has been shortened significantly and, under the final rules, must only contain a statement of whether the compensation committee has reviewed and discussed the CD&A with management and whether it has recommended that the CD&A be included in the company's annual report and the proxy statement. The Compensation Committee Report is considered “furnished” and not “filed” with the SEC and therefore will be subject to less stringent liability standards under applicable securities laws than the CD&A.

Total Compensation Disclosure

The next section of the executive compensation disclosure describes total compensation for NEOs through tabular and narrative disclosure under the Summary Compensation Table (SCT) and the Grants of Plan-Based Awards Table.

Summary Compensation

Table Under the final rules, the SCT remains the centerpiece of a company's tabular disclosure of executive compensation for its three most recent fiscal years. As under current rules, the final rules require that the SCT be augmented by several supplemental tables covering, among other things, holdings of equity-based interests, retirement and other post-employment compensation. The SCT and its supplemental tables make significant revisions to the tables required by the current rules. The SCT and other tables described in this Client Alert can be viewed at <http://www.sec.gov/rules/final/2006/33-8732.pdf>.

Determining Named Executive Officer—As under the current rules, tabular disclosure of compensation is required for those employees identified as named executive officers (NEOs). Under the final rules, NEOs include any person who serves as the company's principal executive officer (PEO) or principal

financial officer (PFO) during the last completed fiscal year. NEOs also include the company's next three most highly compensated executive officers (other than the PEO and PFO) serving as of the end of the last fiscal year.⁶ Under the final rules, the determination of who qualifies as an NEO is based on total compensation (rather than just base salary and bonus as under the current rules), except that, in a departure from the proposed rules, changes in pension value and nonqualified deferred compensation earnings are excluded when making this determination.

The proposed rules would have required narrative (but not tabular) disclosure in conjunction with the SCT with regard to any employee (up to a maximum of three) who, during the last fiscal year, was more highly compensated than any NEO. This rule was sometimes referred to as the "Katie Couric" rule because it was expected to apply with respect to entertainers, athletes, and other highly compensated non-executives. The final rules did not adopt the Katie Couric rule. Instead, the SEC proposed requiring such disclosure only for employees of large accelerated filers who are not only more highly compensated than any NEO, but also have responsibility for significant policy decisions in the company, a significant subsidiary or a principal business unit, division or function. The SEC is currently soliciting comments regarding this proposal.

Overview of SCT—Under the final rules, the SCT will contain the following eight columns⁷ with respect to compensation received by NEOs during the company's three most recently completed fiscal years:

- salary,
- bonus,
- stock awards,
- option awards,
- non-equity incentive plan compensation,
- change in pension value and nonqualified deferred compensation earnings,
- all other compensation.

The final rules require that all compensation be included in this table in the fiscal year in which it is earned (rather than when actually paid). This is the case even when such compensation remains subject to forfeiture conditions. In addition, all columns in the SCT are to be denominated in dollar values (rather than share or unit numbers). The adopting release accompanying the final rules also confirmed that there will be a transition period to the new rules with the compensation information required to be included in the SCT expanding from one to two to three years' information over time. For example, for companies with calendar year fiscal years, the SCT in the 2007 proxy will include only 2006 information; the SCT in the 2008 proxy will include information for 2006 and 2007; and finally, in 2009, the SCT will include information for a full three years (2006, 2007, and 2008). Accordingly, there will be no need for companies to "restate" compensation disclosure for fiscal years covered by the current rules.

Salary and Bonus—Under the final rules, all earned salary and bonus (cash and non-cash, including salary and bonus that is deferred) is included in the fiscal year in which it is earned in the appropriate column.⁸ If earned but deferred salary or bonus compensation is not calculable at the time of disclosure, the company must include footnote disclosure and is obligated to update its disclosure with a Form 8-K when such compensation becomes calculable (either through a payment, a decision to make a payment or another occurrence as a result of which the amount becomes calculable in whole or in part).⁹ Furthermore, in a departure from the current rules, bonuses received by an NEO under a company's performance-based bonus plan will generally be included in the Non-Equity Incentive Plan Compensation column, rather than the Bonus column.

Stock Awards—The grant date fair value for all stock awards (*e.g.*, restricted stock, restricted stock units, phantom stock, phantom stock units, common stock equivalent units, or other similar awards which do not have option-like features) is required to be included in the Stock Awards column. The final rules require that the grant date fair value of such awards be computed in accordance with FAS 123R.¹⁰ The final rules require footnote disclosure of the assumptions used in the fair value determination.

Option Award—The final rules require that the grant date fair value of all stock option awards (including stock appreciation rights), as determined in accordance with FAS 123R, be disclosed in the Option Awards column.¹¹ The final rules require footnote disclosure of the assumptions used in the fair value determination.

Non-Equity Incentive Plan Compensation—The Non-Equity Incentive Plan Column will perhaps be the most unfamiliar new column in the SCT for companies accustomed to operating under the current rules. It requires the disclosure of all awards earned during a fiscal year pursuant to non-equity incentive plans.¹² It includes all incentive awards that are not included in the stock awards or option awards columns. Most significantly, this column will include amounts earned under performance-based cash bonus plans (whether single year or multi-year) that, under the current rules, would have appeared in the Bonus column. If the performance measure for an award is satisfied in a fiscal year, the award must be disclosed even if payment of the award is deferred. Also, earnings on the outstanding awards must be disclosed. Footnote disclosure must identify and quantify awards and payment terms.

Change in Pension Value and Nonqualified Deferred Compensation Earnings—Under the final rules, the aggregate increase in the actuarial value of any defined benefit pension plan must be disclosed.¹³ This disclosure applies to both tax-qualified defined benefit plans and non-tax-qualified supplemental executive retirement plans. In addition, for plans that are not defined benefit plans, above-market earnings on nonqualified deferred compensation must be disclosed (and disclosure may be limited to the above-market or preferential portion).¹⁴ Footnote disclosure must separately identify and quantify these amounts.

All Other Compensation—All compensation not disclosed in any other column of the SCT is required to be disclosed in the All Other Compensation column.¹⁵ Included in this column is the value of any severance payments, change in control payments, company contributions to defined contribution plans, company-provided insurance premiums, company provided tax gross-ups and all perquisites and other personal benefits (unless all such perquisites and other personal benefits have an aggregate value of

less than \$10,000). Perquisites and other personal benefits must be described in the footnotes in a level of detail sufficient that a stockholder may identify the particular nature of the benefits received. In the adopting release, the SEC has provided additional guidance to assist evaluating when a particular item is a perquisite or personal benefit. In particular, an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties. For example, the provision to an NEO of a "Blackberry" or laptop computer may be integrally and directly related to the performance of the executive's duties and thus not a perquisite. Otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, regardless of whether it is provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees. Examples of items that may be required to be disclosed as perquisites and personal benefits include:

- personal club memberships (not used exclusively for business purposes),
- personal financial or tax services,
- personal travel on a company owned or leased vehicle (such as company aircraft) even if required for security reasons,
- personal use of company property,
- housing expenses (including relocation assistance),
- commuting expenses,
- security related expenses,
- discounted purchase of company products (unless generally available to all employees).

Total Compensation—The Total Compensation column, which under the final rules appears on the far right hand side of the SCT, sets forth the sum total of all of the preceding columns of the SCT.¹⁶ As the name suggests, it is intended to provide a single aggregate dollar value for compensation of each NEO with respect to a fiscal year.

Grants of Plan-Based Awards Table

The final rules have consolidated all disclosure for plan-based awards (including stock awards, option awards and non-equity incentive compensation awards) into a single table called the Grants of Plan-Based Awards Table. As discussed above, non-equity incentive compensation awards will include performance-based awards which, under the current rules, were included in the Bonus column of the SCT. The Grants of Plan-Based Awards Table includes each award's (i) grant date, (ii) estimated future payouts, (iii) the number of shares of stock or units underlying a stock or option award, and (iv) the exercise or base price of an option award.¹⁷ Estimated future payouts must be disclosed at threshold, target and maximum amounts (shown in dollars for non-equity incentive plan awards and shares for equity incentive plan awards).

In conjunction with the Grants of Plan-Based Awards Table, additional tabular disclosure is required with respect to options if (i) the exercise or base price is different than the closing market price as of the date of grant (in which case an adjoining column showing the closing market price as of the date of grant would be required) or (ii) the grant date¹⁸ is different from the date on which the compensation committee or full board of directors took action to grant the option or was deemed to have taken such action (in which case an adjoining column showing such date would be required). Additionally, if the exercise or base price is different than the closing market price as of the date of grant, narrative disclosure including a description of the methodology for determining such price is required.¹⁹

Narrative Disclosure Relating to Summary Compensation and Plan-Based Awards Tables

The final rules require a company to provide narrative disclosure following the SCT and Grants of Plan-Based Awards tables of additional material factors necessary to give context to these tables. According to the adopting release, the determination of whether information will be required to be disclosed will be determined based on a facts and circumstances analysis. Importantly a description of

an NEO's employment agreement may be a material factor that is required to be described in the narrative disclosure. In addition, vesting and other terms of equity compensation awards disclosed in the Grants of Plan-Based Awards table may need to be described in the narrative disclosure.

Equity Awards Tables

The third section of the compensation disclosure relates to holdings of previously granted equity awards and amounts realized upon exercise or vesting of previously granted equity awards during the last fiscal year and takes the form of two new tables entitled the Outstanding Equity Awards at Fiscal Year-End Table and the Option Exercises and Stock Vested Table. These new tables replace the current aggregate option/SAR exercise table and fiscal year-end option/SAR value tables.

Outstanding Equity Awards at Fiscal Year-End Table

The Outstanding Equity Awards at Fiscal Year-End Table discloses all equity-based compensation awards outstanding at the fiscal year end, whether or not it is performance based.¹⁹ This table is intended to provide a method of estimating potential amounts realizable by each NEO with respect to outstanding equity-based awards. With respect to option awards, the Outstanding Equity Awards at Fiscal Year-End Table requires disclosure on an award-to-award basis regarding; (i) the number of securities underlying unexercised options (with separate columns for options that are exercisable and options that are unexercisable), (ii) the number of securities underlying unexercised unearned options issued pursuant to an equity incentive plan, (iii) the exercise price, and (iv) expiration date. With respect to stock awards, this table requires disclosure regarding the number of shares that have not vested and the market value of shares that have not vested (in both cases, distinguishing between those granted pursuant to an equity incentive plan and those which were not). Footnote disclosure must include a description of the vesting dates of awards.

Option Exercises and Stock Vested Table

The Option Exercises and Stock Vested Table sum-

marizes all amounts realized on the vesting and exercise of any equity-based compensation awards in the latest fiscal year.²⁰ With respect to both option and stock awards, this table requires disclosure of the number of shares acquired and value realized upon exercise or vesting.

Retirement and Other Post-Employment Benefits

The final rules substantially revise the current rules regarding disclosure of retirement and other post-employment benefits.²¹ The final rules replace the current Pension Plan Table with two new tables, the Pension Benefits Table and the Non-Qualified Deferred Compensation Table. The final rules also require more detailed narrative disclosure regarding compensation paid upon termination of employment or change in control, including estimates of potential payouts.

Pension Benefits Table

The Pension Benefits Table requires disclosure of the actuarial present value of each NEO's accumulated benefit under any of the company's defined benefit plans (including tax-qualified and nonqualified defined benefit plans).²² The present value is calculated as of the measurement date used in the financial statements for the company's last completed fiscal year, taking into account the executive's current compensation, the plan's normal retirement age and the same actuarial assumptions used for financial reporting purposes under GAAP. However, disclosure is made without regard to the forms of benefits available under the plan. This table also requires disclosure of each NEO's years of credited service (with a footnote describing any credited service that exceeds the NEO's actual service) and payments received during the company's last fiscal year under each plan. A separate row of disclosure is required for each defined benefit plan in which the NEO participates.²³ In addition, this table must be accompanied by a narrative description of all material factors necessary to interpret the table. Such factors include, but are not limited to, (i) the plan's benefit formula, eligibility standards and early retirement arrangements (if any NEO is currently eligible for such arrangements), (ii) how compensation is defined for purposes of the plan, (iii) the reasons for multiple plans and (iv) the company's policy regarding credit-

ing extra service. The narrative description should also set forth the actuarial assumptions used to calculate the present value of each NEO's accumulated benefits, unless such assumptions are incorporated by reference to permissible sources (*e.g.*, the company's financial statements).

Non-Qualified Deferred Compensation Table

The Non-Qualified Deferred Compensation Table requires disclosure, with respect to each NEO during the company's last fiscal year, of the NEO's and the company's contributions and all earnings, withdrawals and distributions under any non-qualified defined contribution plans (including non-qualified deferred compensation plans).²⁴ This table also requires disclosure of each NEO's last fiscal year-end balance under such plans. A footnote must be added to the table in order to avoid "double counting" of plan contributions and earnings (*e.g.*, amounts deferred under any nonqualified defined contribution plans, and any above-market or preferential earnings thereon, would also be disclosed in the SCT and therefore would overstate the amount of an NEO's compensation).²⁵ This table must also be followed by a narrative description of all material facts necessary to understand the table. Such factors include, but are not limited to (i) the types of compensation which may be deferred and any limitation on such deferrals, (ii) the method of calculating and quantifying interest rates and other earnings measures, and (iii) material terms relating to payouts, withdrawals and distributions.

Severance and Change in Control Payments

The final rules require companies to provide specific narrative disclosure of the amount of any payment or benefit that an NEO may receive upon termination of employment, change in responsibilities, or upon a change in control, including any tax gross-up payments and post-termination health care benefits.²⁶ Specifically, the final rules require disclosure of the following regarding such payments and benefits:

- the specific circumstances that would trigger payment,
- quantitative and narrative disclosure regarding the estimated payments and benefits, even where

uncertainties exist as to amounts payable under the particular arrangement,

- disclosure regarding when the payments and benefits are paid (*e.g.*, lump sum or over time),
- how the payments and benefits are determined,
- the material conditions and obligations applicable to the receipt of the payments and benefits (*e.g.*, non-competition restrictions), including any provisions regarding waiver or breach of these provisions,
- any other material factors regarding the agreement governing such payments.

For purposes of quantitative disclosure, companies may assume that (i) the event triggering the provision of a payment or benefit took place on the last business day of the company's last fiscal year and (ii) the price per share of the company's stock, if applicable, equals the closing market price on such day. Companies are not required to disclose payments or benefits that do not discriminate in favor of a company's executive officers and are available generally to all salaried employees.

Directors Compensation Disclosure

The discussion of directors' compensation was substantially revised in the final rules to include a Directors Compensation Table with accompanying narrative.²⁷ The Directors Compensation Table resembles the SCT but only presents information with respect to the company's last fiscal year. Columns in the table include:

- fees earned and paid in cash,
- stock awards,
- option awards,
- non-equity incentive plan compensation,
- change in pension value and non-qualified deferred compensation earnings,
- all other compensation,

- total compensation.

Directors may be grouped in a single row if all their elements and amounts of compensation are identical.

The All Other Compensation column includes items similar to those included in the SCT for executive officers. The final rules identify several items that must be included in that column, the most significant of which are:

- value of perquisites and other personal benefits unless the aggregated amount of such compensation is less than \$10,000,
- awards under director legacy or charitable awards programs,
- consulting fees,
- all tax reimbursements,
- discount stock programs not generally available to employees,
- contributions or allocations to defined contribution or other deferred compensation plans,
- actuarial increases in defined benefit pension plans,
- value of life insurance premiums paid by the company for the director's benefit,
- payments in connection with the director's resignation, retirement, termination or change in control of the company.

Items in the All Other Compensation column over \$10,000 in value must be separately identified and quantified in a footnote. Also, the aggregate numbers of stock awards and option awards held by the director at fiscal year end must also be disclosed in a footnote to the appropriate column.

Any material information that is necessary to understand the amounts disclosed in the table would be described in narrative format following the table. Such disclosure may include, for example, a breakdown in the cash compensation between annual

retainer and meeting fees. If directors receive stock options, then disclosure regarding option timing or dating practices similar to those described above for executives would also need to be included.

Effective Dates

The final rules require companies to be in compliance when filing proxy statements and Forms 10-K for fiscal years ending on or after December 15, 2006. In addition, registration statements filed with the SEC on or after December 15, 2006 that are required to include Item 402 and 404 disclosures with respect to fiscal years ending on or after December 15, 2006 are required to be in compliance with the final rules.

With respect to Forms 8-K, companies must comply with the final rules for triggering events that occur on or after November 7, 2006.

Amendments to Form 8-K

The final rules also revise the periodic reporting requirements relating to executive compensation. In connection with amendments to Form 8-K in 2004 and the introduction of Item 1.01, the SEC adopted changes requiring accelerated reporting of a company's entering into a material definitive agreement, which had the effect of covering most executive compensation arrangements. The new rules purport to streamline the disclosure requirements with respect to executive compensation arrangements by introducing materiality thresholds intended to limit disclosure to those agreements and arrangements that are "unquestionably or presumptively material." The final rules eliminate disclosure of executive compensation arrangements from Items 1.01 and 1.02 of Form 8-K (Entry Into and Termination of Material Definitive Agreements) and moves the revised disclosure requirements to Item 5.02, which now covers all current report disclosure with respect to compensation arrangements.

Previously, Item 5.02 required the disclosure of the retirement, resignation or removal of the company's PEO, president, PFO, principal accounting officer, principal operating officer or any person performing a similar function. The new rules expand this list to include any NEO. In addition, the new rules supple-

ment the existing disclosure requirements of Item 5.02 and now require:

- A brief description of any material plan, contract or arrangement to which the covered officer or director is a party or in which the officer participates that is entered into or materially amended in connection with the officer's appointment or departure, or a director's election or departure, and any awards under such plan, contract or arrangement.²⁸
- A brief description of any material new compensatory plan, contract or arrangement to which the company's PEO, PFO, or any NEO participates or is a party, whether or not in connection with an officer's appointment, and any material amendment to such compensatory plan, contract or arrangement, or any material grant, or modification of a grant, made under such compensatory plan, contract or arrangement, unless consistent with the previously disclosed terms of the plan, including the amounts payable to the officer.²⁹
- Disclosure of any payment, grant, award or decision affecting the salary or bonus of an NEO if the information could not have been calculated as of the time of filing of the company's proxy statement and was not included in the SCT, including an update of the calculation of total compensation for such NEO.³⁰

These new rules apply to oral as well as written plans, contracts or arrangements. For purposes of these disclosures, NEOs are those executive officers for whom disclosure was required in the company's most recent filing with the SEC. The commentary in the release emphasizes that the new Form 8-K disclosures are intended only to be brief descriptions, and not intended to require all of the information necessary to otherwise comply with the annual reporting requirements applicable to executive compensation. The new rules also expand the safe harbor requirements under Section 10(b) and Rule 10b-5, and Form S-3 eligibility requirements, for a failure to timely file reports required by Item 5.02(e).

Amendments Regarding Certain Relationships, Related Party Transactions and Corporate Governance Disclosures

The new rules also amend the Certain Relationships and Related Transactions disclosure requirements of Item 404 of Regulation S-K and create a new Item 407 which expands and consolidates certain corporate governance disclosures.

Transactions with Related Persons—The new rules adopt a principles based approach to the disclosure of certain relationships and related transactions, as opposed to the bright line standards embodied in the existing rules. The new rules expand the scope of the transactions covered by the disclosure requirements to include any individual or series of financial transactions, arrangements, or relationships in which:

- The company benefits from the transaction, even if not a contractual party to the arrangement,
- The amount exceeds \$120,000,
- The related person had or will have a direct or indirect material interest, determined on the basis of the significance of the information to investors, in light of all of the circumstances, including consideration of the relationship of the related persons to the transaction, their relationship to each other and the importance of the interest to the person having the interest.³¹

The rules provide for exceptions to the disclosure requirements for: executive compensation arrangements otherwise reported under Item 402 of Regulation S-K (other than in the case of an immediate family member); indebtedness incurred in connection with the purchase of goods and services on usual trade terms; ordinary course business and travel advances and reimbursements; loans from banks, savings and loans and broker-dealers in the ordinary course of business on prevailing market terms and which are not subject to more than a normal risk of collectibility; transactions in which the related person's interest arises solely because of their position within, or ownership of less than a 10 percent beneficial interest of, another entity that is party to the transaction; transactions involving competitive

bids or priced at regulated rates; certain fiduciary or similar financial services; or the pro rata benefit applicable to a class of equity security holders.³²

Procedures for Approval of Related Person Transactions—The new rules also require the disclosure of policies and procedures adopted by the company and its board of directors for the review, approval or ratification of related person transactions. The disclosure requires a description of the material features of the policies and procedures, such as:

- The types of transactions that are covered and the standards to be applied,
- The members of the company's board of directors responsible for applying the policies and procedures,
- Whether the policies and procedures are in writing, and if not, how such policies and procedures are documented.

The new rules expressly require the identification of any transactions where the company's policies and procedures do not otherwise require review, approval or ratification, or circumstances in which the policies and procedures were not followed.³³

Promoters and Control Persons—The rules requiring disclosure of promoters and transactions with promoters has been broadened to cover the last five fiscal years. Previously, the disclosure requirement did not apply to transactions with promoters if the company had been organized more than five years.³⁴

Corporate Governance Disclosure—The new rules create Item 407 of Regulation S-K, which consolidates existing disclosure requirements regarding director independence and related corporate governance matters.

Director Independence—Under the new rules, companies must identify their independent directors and director nominees, and state the standards (including, as applicable, those required by any listing standards of any national securities exchange or inter-dealer quotation system on which the companies securities are listed or to which it has applied for listing) by which the directors or nominees are determined to be independent, including identification of the com-

mittees on which they serve and the independence standards applicable to service on the committees. Companies must also disclose for each director or director nominee the type of transactions, relationships and arrangements considered by the board of directors in determining director independence. The required disclosures are applicable to a director that served any portion of the year for which disclosure is required, even if the person no longer serves at the time of the filing requiring the disclosure.³⁵

Compensation Committee—The new rules also adopt the following compensation committee disclosures, which follow those already applicable to audit committees and nominating committees. Under the new rules, the company will be required to disclose:

- whether the compensation committee has a charter, and whether the charter is available through the company's Web site or proxy materials,
- the committee's processes and procedures for the consideration and determination of executive and director compensation, including the committee's scope of authority, the extent and scope of any delegated authority, the role of executive officers in determining or recommending executive officer and director compensation, and the identity and role of compensation consultants.

The commentary in the adopting release emphasizes that the disclosure is intended to focus on the aspects of corporate governance affecting the determination of executive compensation and supplements the separate CD&A section required by the new rules.³⁶

Notes

1. These final rules can be found at <http://www.sec.gov/rules/final/2006/33-8732.pdf>.

2. Item 402(b).

3. Item 402(b)(1).

4. Item 402(b)(2).

5. See Instruction 4 to Item 402(b)(4).

6. The group of NEOs may include up to two additional individuals for whom disclosure would have been required had such individual(s) been serving as of the end of the last fiscal year [see Item 402(a)(2)(iv)]. Although this is consistent with the current rules, because NEO status is generally based on total compensation (rather than just base salary and bonus), we expect that it will be more common for companies to include additional NEOs pursuant to this rule. See Item 402(a)(3)(iv).

7. Item 402(c).

8. Item 402(c)(2)(iii).

9. Instructions to Item 402(c)(2)(iii) and (iv).

10. Item 402(c)(2)(v).

11. Item 402(c)(2)(vi).

12. Item 402(c)(2)(vii).

13. Item 402(c)(2)(viii)(A).

14. Generally interest on deferred compensation is considered to be above-market if the rate of interests exceeds 120 percent of the applicable federal long-term rate. See Item 402(c)(viii)(B). Instruction to Item 402(c)(2)(viii).

15. Item 402(c)(ix).

16. Item 402(c)(2)(x).

17. Item 402(d).

18. Under the final rules, the grant date is generally considered to be the day the decision is made to award the option, provided that the recipient of the option is notified promptly.

19. Item 402(e).

20. Item 402(f).

21. Item 402(g).

22. Item 402(h).

23. The Pension Benefits Table under the final rules is significantly different than such table as proposed under the proposed rules. For example, the proposed rules would have required disclosure with respect to the estimated normal retirement and early retirement annual benefits of each NEO under any of the company's defined benefit plans. Furthermore, under the proposed rules, payments received by an NEO under any defined benefit plans during the company's last fiscal year were to be included in the All Other Compensation column of the SCT and not a separate column of the Pension Benefits Table.

24. Item 402(i).

25. Under the proposed rules, a similar explanatory footnote to avoid “double counting” of non-qualified defined contribution plan deferrals and earnings would also have been required with respect to the SCT.

26. Item 402(j).

27. Item 402(k).

28. Item 5.02(c)(3) and Item 5.02(d)(5).

29. Item 5.02(e).

30. Item 5.02(f).

31. Item 404(a).

32. Instructions 6 and 7 to Item 404(a).

33. Item 404(b).

34. Item 404(c).

35. Item 407(a).

36. Item 407(e).