FENWICK & WEST LLP

Corporate and Securities Law Update

SEC Rule Proposal Creates Current Action Items

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As we described in previous alerts, the SEC has proposed sweeping new rules governing public company disclosure of executive and director compensation arrangements and related party transactions. If the proposals are adopted, public companies will file Forms 10-K and proxy statements next year containing disclosures based on the new rules. The prospect of these disclosures should be kept in mind today as companies consider all their executive compensation matters. In addition, the proposals contain interpretive guidance about perquisites that are relevant to current proxy disclosures.

EIGHT REASONS TO WORRY (NOW) ABOUT THE NEW RULES

1. New Focus on Total Value of All Compensation. The proposed rules require that all elements of executive compensation be included in the modified Summary Compensation Table. A dollar amount for total compensation will be the centerpiece of the table and will undoubtedly receive the most press, employee and competitor attention. These high-visibility disclosures next year will reflect decisions made by compensation committees in 2006. Even where a company does nothing new in 2006, executive compensation information will be presented very differently than in the past. For example, the dollar value of equity compensation grants (rather than share amounts) and earnings on deferred compensation (even deferred compensation invested in mutual funds) will be included in the chart and in the total compensation amount. Each option grant will be valued at its full FAS 123R value on date of grant, irrespective of vesting. As a result, executive compensation totals will often appear higher than in the past.

In light of these changes, companies and compensation committees making decisions about executive compensation today would be well-advised to use tally sheets, and to calculate a pro forma value of the totality and each part of their executive officer compensation programs. Companies should also be aware that total compensation—rather than salary and bonus—would be used under the new rules to determine which persons are identified as the company's "named executive officers." An option grant, such as a large refresh grant to a current executive officer or an initial grant to a new executive, could trigger new disclosure for that person.

2. Severance and Change of Control Arrangements. The proposals also call for new and detailed narrative disclosures about severance and change of control arrangements, including disclosure of specific dollar amounts of payments that may be made to executives upon termination or a change of control. In some cases this quantification will be difficult. Valuations could be taken out of context when they appear in an annual proxy statement rather than in the context of the corporate event that triggers the payments. Narrative disclosure would also be required about the specific factors the company used to determine the appropriate payment levels.

Companies considering new or modified severance and change of control arrangements in 2006 would be well advised to calculate the required hypothetical values of equity awards and any golden parachute payment tax gross-ups, to understand the myriad assumptions associated with such calculations, and to anticipate any issues that might be associated with the new disclosures. Companies should also be aware that entering into such an agreement may constitute a modification of an equity award, triggering additional disclosures (see item 4 below).

3. Compensation of Highly-Paid Non-Executive Employees. A new group of employees is targeted for compensation disclosure under the proposed rules. Specifically, total compensation for the year would be provided for up to three employees who were not executives but whose compensation exceeded that of any of the "named executive officers." There is a good chance that this proposal will be eliminated when the rules are debated and finalized. However, if it survives, the compensation and job titles of highly-paid sales personnel, or key non-executive technology personnel, would have to be reported by some

companies. Such disclosures might be a source of employee friction, or might help competitors to recruit key personnel.

4. Modification of Equity Awards. The proposed rules require companies to include the full FAS 123R value of any stock option or other equity awards that are modified during the year. Full FAS 123R grant value is required notwithstanding that FAS 123R itself permits an offset for the value of the equity award prior to modification. As a result, even a modest modification to an equity award, including something as common as extending the post-termination exercise period of an option until the end of the calendar year, could lead to option value disclosure that is grossly inflated. In combination with the proposal that the full grant date value of an option be shown as compensation, rather than prorated as is required for accounting purposes under FAS 123R, the result could be seriously inflated values of total compensation.

Compensation committees should be aware of this potential pitfall when considering modification of equity awards in 2006, and should confer with the company's independent auditor to ensure there is no confusion about what constitutes a modification. As discussed above, these option value rules could affect the determination of which persons are identified as the company's named executive officers, since total compensation rather than salary and bonus will be used to make that determination.

5. Governance Disclosure. Companies for the first time will be required to disclose corporate governance information about the compensation committee and how the company determines executive compensation, including:

- The extent to which the compensation committee may delegate authority to make compensation decisions;
- What role executive officers play in determining or recommending the amount or form of executive or director compensation; and
- Any role of compensation consultants, identifying them and the scope of their assignment.

To prepare for these disclosures, the compensation committee should review its charter, delegations of authority and other executive compensation processes in the coming months, to ensure that they are structured and operating as intended. When the company or compensation committee retains a compensation consultant in 2006, the company should bear in mind that there is likely to be new disclosure about that relationship. As proposed, the disclosure would identify the consultant, state whether the consultant was engaged directly by the compensation committee or another person, describe the nature and scope of the consulting assignment, disclose the material elements of the instructions given to the consultant, and identify any executive officer that the consultant contacted in carrying out the assignment.

6. Related Party Transaction Review. The new rules would require companies to describe their policies and procedures for review and approval of related party transactions. Nasdaq listing standards already require that the company review all related party transactions for potential conflict of interest situations, and that all such transactions be approved by the audit committee or another independent body of the board of directors, so most companies currently have procedures in place. As proposed, companies would also be required to identify any related party transaction that did not require review and approval, and or any transaction where company procedures were not followed. Companies may wish to revisit these policies and procedures in coming months to determine whether any changes are appropriate.

7. Perquisites. The rule proposal contains useful interpretive guidance from the SEC about perquisites disclosure. This guidance has immediate relevance for current proxy statements, as well as for choices to be made about perquisites this year. While the SEC eschewed any bright-line definition of the term "perquisite or other personal benefit," it did discuss the principles to be used in determining whether an item is a perquisite, and in valuing those items. Under the SEC's principles:

- An item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, even if it is provided for a business reason, unless it is generally available to all employees on a non-discriminatory basis.
- An item is not a perquisite if it is "integrally and directly related to the performance of the executive's duties."
- The appropriate way to measure the value of a perquisite is to determine the actual aggregate incremental cost to the company of providing the benefit.

Generally, the SEC expects "perquisite or other personal benefit" to be interpreted broadly, and "integrally and directly related to the performance of duties" to be interpreted narrowly.

These are examples of items that would require disclosure as perquisites:

"…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."

These are examples of items that would not be perquisites (no required disclosure):

"… among other things, travel to and from business meetings, other business travel, business entertainment, security during business travel, and itemized expense accounts the use of which is limited to business purposes."

Another example applies the perquisite principles to executive office space:

"[A]n office at the job location, even if larger than that of other employees, is integrally and directly related to performance of the executive's job, as is secretarial service used for business purposes, even if at a higher level than other employees. On the other hand, provision of additional secretarial services, such as a second secretary, that is not directly related to performance of an executive's job would be a perquisite or personal benefit."

Beyond these examples, the SEC leaves it up to companies and their advisors to determine from the facts of particular situations whether perquisite disclosure is required.

This interpretive guidance is the SEC's attempt to improve the identification and valuation of perquisites that are required even under existing disclosure rules. To underscore the importance of this point, the proposal reminds companies that in the past the SEC has taken enforcement action against companies that did not properly report perquisites. For the current proxy season, we suggest that companies identify and assess any perquisites that are being provided to executives, and ensure that the "aggregate incremental cost" is used to value those perquisites in the current Form 10-K or proxy statement.

8. Compensation Discussion and Analysis. The proposal mandates an extensive narrative overview of the design and implementation of the company's executive compensation program. The section is expected to be comprehensive, covering post-termination as well as in-service compensation arrangements. It is expected to focus on the material principles underlying all executive compensation policies and decisions, and the most important factors relevant to analysis of those policies and decisions. Disclosure would go well beyond what is currently provided in a typical compensation committee report. Further, unlike compensation committee reports, the new CD&A would be deemed "filed" with the SEC, thus subject to the same liability standards that apply to other annual report or proxy statement disclosures. The CD&A would be within the scope of CEO and CFO certifications. In preparing this disclosure, companies should bear in mind that it may be subject to later litigation over alleged material misstatements or omissions.

Conceptually, the compensation discussion and analysis must explain all material elements of the company's compensation for its named executive officers by answering the following questions:

- What are the objectives of the company's compensation program?
- 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?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How does 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?

Companies would be well advised to familiarize themselves with the new disclosure mandates, and to think prospectively about their compensation programs with a view to future disclosures, such as:

- The policies for allocating between long-term and current compensation, and between cash and equity compensation;
- How the timing of equity awards was determined;

- The specific items of corporate performance taken into account in making compensation decisions;
- How a form of compensation reflects corporate performance or the specific performance of the individual executive;
- Why different compensation elements are weighted as they are;
- Factors considered in materially increasing or decreasing compensation;
- Whether the company engaged in benchmarking of total compensation or any element of compensation, identifying benchmark companies; and
- The role of executive officers in the compensation process.

If you would like information on the executive compensation and related party disclosure rule proposals, or if you wish to discuss the implications of potential changes on your company, please call any member of your Fenwick & West team, or contact one of the individuals listed below.

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