FENWICK & WEST LLP

Corporate and Securities Law Update

SEC Adopts Sweeping Changes to Executive and Director Compensation Disclosure Rules

AUGUST 22, 2006

On July 26, 2006, the SEC adopted sweeping changes to its rules for disclosing compensation of executive officers and directors of public companies, information about related person transactions, director independence and other corporate governance matters. These changes will generally be effective for the 2007 proxy season. The SEC also adopted changes to Form 8-K disclosure requirements, limiting "real time" disclosures of management contracts and compensatory plans, contracts and arrangements and consolidating all Form 8-K disclosures regarding management and director issues under a single item. The Form 8-K changes will be effective 60 days after the final rules are published in the Federal Register. The full text (430+ pages) of the final rules, SEC Release No. 33-8732, was made available on August 11, 2006 and can be found at www.sec.gov/rules/final/2006/33-8732.pdf.

This client alert summarizes the key aspects of these new rules, the compliance dates for which are addressed below. Because the new disclosures require information that is different than what was required in the past, it is important to begin, ***now***, to take action to prepare for the disclosures. Some of the actions that we suggest companies may want to take include:

- Evaluate existing policies, procedures and systems (including disclosure controls and procedures and internal control over financial reporting) to assess what changes need to be made in order to comply with these new disclosure requirements.

- Develop a timeline for making any needed changes, gathering the information necessary to respond to the new rules, drafting the new disclosures and obtaining the input of relevant groups, such as the company's accounting, finance, legal and human resources departments and the company's compensation committee.

- Evaluate who within the company must or should be involved in gathering and analyzing the relevant data and drafting and reviewing the required disclosures.

- Begin to collect the relevant information and prepare a "mock up" of required disclosures.

If you would like information on these executive compensation and related person transaction disclosure rules, or if you wish to discuss the implications of the 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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I. New Executive and Director Compensation Disclosures

The new executive and director compensation disclosure rules are divided into five primary areas:

- Compensation Discussion and Analysis (**"CD&A"**) and a new form of Compensation Committee Report.
- Compensation of named executive officers (**"NEOs"**) for the last fiscal year (and the two preceding fiscal years).
- Grants of equity-related (and incentive plan) interests to NEOs, holdings of outstanding equity-related interests and realization on equity-related interests.
- Retirement plans, deferred compensation and other post-employment payments and benefits for NEOs.
- Director compensation.

The rules continue to rely heavily on tabular disclosure of executive compensation, and now the tables are supplemented with extensive narrative disclosure. New narrative disclosures include, most importantly, CD&A. In addition, supplemental footnotes to the tables and discussions designed to give context to the quantitative tabular disclosures.

With these revisions to its executive compensation disclosure rules, the SEC is seeking to ensure that all elements of compensation are disclosed, and that they are disclosed in a manner that facilitates meaningful comparisons from company to company and from year to year. It is also seeking to make executive compensation information easier to understand in order to provide investors with a clearer and more complete picture of the compensation paid to executives and directors.

Compensation Discussion and Analysis – CD&A

Basic Requirements. At the center of executive compensation disclosure will be a new section entitled "Compensation Discussion and Analysis." This section is designed to be a principles-based, narrative report by the company that provides an overview of the material factors underlying the company's executive compensation policies and decisions. This section should be comprehensive, covering in-service and post-termination compensation arrangements and all types of executive compensation, including enhanced disclosure of executive stock option practices (discussed in more detail below) and employment or change of control arrangements. CD&A should put in perspective for investors the policies and decisions that led to the compensation reflected in the more detailed tables and narrative that follow. CD&A will focus on compensation decisions that were made in the most recent fiscal year, but it may also need to address actions that were taken after fiscal year end and, where necessary to provide context to current compensation disclosures, actions taken in earlier fiscal years. It should clarify material differences in compensation policies and decisions for individual NEOs, but a group discussion of those policies and decisions is acceptable where they are materially similar among the group.

No Boilerplate. The SEC intends that CD&A disclosure will go well beyond disclosure that was formerly included in compensation committee reports, in particular because CD&A will provide material information about the compensation objectives and policies for NEOs. The SEC specifically and repeatedly cautions that "boilerplate" disclosure will not be acceptable. Unlike the current compensation committee reports, which are "furnished" as opposed to "filed" with the SEC, the CD&A will be filed and subject to the same liability standards that apply to other annual report or proxy statement disclosures. It will also be covered by CEO and CFO certifications and disclosure controls and procedures requirements.

Address All Material Elements of Compensation. CD&A must explain **all** material elements of compensation for the company's NEOs, by answering these questions:

- What are the objectives of the company's compensation program?
- What is the 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) for each element?
- How does each compensation element fit into the company's overall compensation objectives, and how do

the company's decisions regarding that element affect decisions regarding other elements?

In preparing to draft CD&A for the 2007 proxy season, companies need to evaluate all of their particular compensation programs, plans and arrangements. Companies will also be required to disclose significant information about their option and other equity grant programs and practices, as discussed separately below. Among the questions that should be considered when drafting CD&A are the following:

- What are the company's policies for allocating between long-term and current compensation, and between cash and equity compensation?
- What is the basis for allocating compensation to each type of long-term compensation award (*e.g.*, related to the company's long-term goals, management's exposure to downside equity performance risk, correlation between cost and expected benefits for the company)?
- How is timing of awards determined – including the timing of options and other equity awards?
- What specific items of corporate performance are taken into account in making compensation decisions, and can discretion be exercised in awarding the targeted compensation?
- How does each element of compensation reflect corporate performance or the specific performance of the individual executive?
- Why are different compensation elements weighted as they are?
- What are the company's policies and decisions regarding the adjustment or recovery of awards or payments if the relevant performance measures are restated or otherwise adjusted in a manner that would reduce the size of an award or payment?
- What factors were considered in materially increasing or decreasing compensation?
- How were amounts realized from prior compensation (such as gains from prior option grants or stock awards) considered in setting other elements of compensation?
- What was the basis for selecting particular events as triggering payment under termination and change of control arrangements?
- What is the impact of accounting and tax treatments of different forms of compensation?
- What are the company's guidelines for ownership of company securities and hedging?
- Does the company engage in benchmarking of total compensation or any element of compensation, and if so which companies were used as benchmark companies?
- What is the role of executive officers in the compensation process?

No Disclosure of Confidential Performance Targets. Performance targets that involve confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm under existing SEC confidential treatment rules, are not required to be disclosed in CD&A (or the tables or related narrative discussions that follow CD&A). However, if they are not disclosed, the company will be required to address how difficult it will be for the executive, or how likely it will be for the company, to achieve the targets.

Practice Tips & Observations: In order to be able to prepare the new CD&A disclosure, companies will want to understand the manner in which information will be displayed in the executive compensation tables and narrative disclosures that are required by the new rules and for which CD&A is designed to serve as an overview. Where applicable, these tables and narrative disclosures may need to be cross-referenced in CD&A. As a result, companies likely will find it useful to get a head start in collecting required information so that it is available to support the preparation of the CD&A and related disclosure.

Analysis of specific policies behind executive compensation is a new exercise for companies that goes beyond the scope of existing compensation committee reports and may require substantial lead time to develop.

Because CD&A requires discussion of tax and accounting treatments of different forms of compensation, the company may need to obtain guidance from its professional tax and accounting advisors in preparing CD&A.

CD&A may require discussion of employment agreements and change of control agreements that are in place during the fiscal year and that are the basis for executive compensation during the fiscal year. This will require companies to review existing agreements in the context of preparing CD&A.

Compensation Committee Report

The new rules require companies to provide a new Compensation Committee Report that at a minimum addresses two specific points. First, whether the compensation committee has reviewed and discussed the company's CD&A with management. Second, whether, based on that review and discussion, the committee has recommended to the board that the CD&A be included in the company's annual report on Form 10-K and, as applicable, its proxy statement.

Like the Audit Committee Report, the new Compensation Committee Report will be "furnished," not filed. It will be required only once during any fiscal year, and the names of each member of the compensation committee (or persons performing the functions of that committee) will appear below the report.

In order to address concerns about CEO and CFO certifications of CD&A disclosure, which is likely to describe actions taken by the compensation committee without the involvement of the these officers, the CEO and CFO may rely on the new Compensation Committee Report in providing their certifications of CD&A.

Practice Tips & Observations: Since compensation committee reports must state whether the committee has reviewed and discussed CD&A with management, companies will want to ensure that they allocate sufficient time to gather CD&A information, prepare and review the required disclosures, and provide them to the compensation committee for review and discussion. Time should also be allowed to educate the compensation committee about the new standards for disclosure.

Disclosures of Option Grant Practices

Option and Other Equity Plan Disclosures. The final rules include expanded disclosures about stock options and other equity plans. These rules respond, in part, to the flood of recent reports of company, SEC and Department of Justice reviews of questionable stock option practices, including allegations of "backdating" of option grants and timing of option grants to take advantage of the release, or withholding, of material non-public information. Expanded stock option disclosures will be found in CD&A and in a new "Grants of Plan-Based Awards" table, discussed separately below.

- CD&A requires enhanced narrative discussion of option grants to executives and directors (including reasons why a company selects options or other equity awards, timing of grants and how exercise price is determined).
- A new "Grants of Plan-Based Awards" table will include detailed information about grants to NEOs under the company's equity incentive plans as well as its and non-equity incentive plans.

Disclosure About Stock Option Timing and Exercise Prices. Enhanced disclosure will be required, in CD&A and in certain parts of the tables and accompanying narrative disclosures, about the timing of stock option grants in relation to the company's release of material non-public information, and any program, plan or practice of setting exercise prices based on the company's stock price on a date other than the actual grant date (including grants under so-called "formula" plans).

In particular, the SEC believes that companies should address the following questions when preparing their CD&A disclosures:

- Does the company have any program, plan or practice to time option grants to executives in connection with the release (or withholding) of material non-public information?
- How does any program, plan or practice to time option grants to executives fit in the context of the company's program, plan or practice (if any) with respect to option grants to employees more generally?
- What role did the compensation committee play in administering the program, plan or practice regarding option grants?
- How did the board or compensation committee take into account the information to be released, when

determining whether and in what amounts to make option grants?

- Did the compensation committee delegate any aspect of the actual administration of a program, plan or practice to any other person?
- What role did the company's executive officers play in the program, plan or practice of option timing?
- Does the company set the grant date of its stock option grants to new executives in coordination with the release of material non-public information?
- Does the company plan to time, or has it timed, its release of material non-public information for the purpose of affecting the value of executive compensation?

Companies will also be required to provide enhanced tabular disclosure reflecting any difference between the exercise price of an option and the closing market price on the date that the award was made by the compensation committee or board, as well as the reason for any difference.

Practice Tips & Observations: We understand that even though this SEC guidance is specifically addressed to options, the same principles will apply to other equity grants, such as stock appreciation rights, restricted stock and restricted stock units. The SEC has indicated that disclosure of similar information related to director grants should also appear in the narrative accompanying the new Director Compensation table. Accordingly, until additional guidance is provided, we recommend that companies consider providing disclosure of this sort for all forms of equity grants, and for all executives and directors to the extent applicable.

In order to prepare for these new disclosures, companies should assess their practices regarding the timing of option grants during the current fiscal year, and whether any changes to, or formalization of, those practices should be made. Companies should also assess their practices regarding option exercise prices for the fiscal year, and whether any changes to those practices are needed. To respond to the more general option disclosure requirements of CD&A, companies should review their standard practices and the terms of their option plans and agreements, and any deviations from those terms for executive officers, to assess the types of disclosures they will need to include, and to assess whether they should make any changes to their standard option grant terms and procedures. Companies should review their formal SOX 404 description of option grant policies and procedures and update as necessary.

How Named Executive Officers Are Identified

The focus of the final executive compensation rules, highlighted by the revised Summary Compensation Table, is on compensation information for NEOs, the definition of which has changed. Going forward, the NEOs will be:

- any person who served during the last fiscal year as the principal executive officer (usually the CEO),
- any person who served as the principal financial officer (usually the CFO), and
- the three most highly compensated executive officers who were serving as such at the end of the company's fiscal year and who earned compensation in that year of at least $100,000.

In addition, consistent with existing rules, up to two additional executives who were no longer serving as such at the end of the company's fiscal year must also be included as NEOs if their total compensation exceeded that of any one of the other three executives named in the table.

Identification of the most highly compensated executive officers will be based upon total compensation for the last fiscal year (excluding the earnings on deferred compensation and the actuarial increase in pension benefit accruals that are included in the Summary Compensation Table), compared to just salary and bonus under the existing rules. As a result, an option grant, such as a large refresh grant to a current executive officer or an initial grant to a new executive, could cause that person to become an NEO. The SEC no longer permits exclusion of unusually large amounts of cash compensation, not part of a recurring arrangement and unlikely to continue, in identifying the NEOs.

Practice Tips & Observations: With the change from salary and bonus to total compensation as the relevant metric for determining NEO status, companies should assess their systems for valuing, gathering and analyzing the information that goes into total compensation. Companies should assure themselves that they are able to produce a "total compensation" amount for current executives and for those who served as an executive during the year. In addition, the switch to total compensation means that large equity or other incentive plan awards may raise the compensation of an individual executive sufficiently for him or her to be one of the three most highly compensated executives other than the CEO and CFO, so companies may want to assess in advance who are likely to be the NEOs included in the Summary Compensation Table for fiscal 2007.

Re-proposal of "Katie Couric" Provision

The final rules did not adopt one of the more controversial provisions of the original rule proposals, which had targeted compensation disclosure about a new group of non-executive employees – the so-called "Katie Couric" provision. As proposed, total compensation for the year would have been provided for up to three employees who were not executives but whose compensation exceeded that of any of the NEOs. As re-proposed, disclosure would be required only for employees with significant policy-making authority within the company, a significant subsidiary or a principal business unit, division or function, and it would only apply to large accelerated filers (those with greater than $700 million in market capitalization). Further, the disclosure would be provided in narrative, rather than tabular, format and would not require the disclosure of the individual's name but only his job position.

Summary Compensation Table – Focus on Total Compensation, Including Value of Equity Awards

Overview. The revised Summary Compensation Table and accompanying supplemental narrative disclosures remain the principal vehicle for executive compensation disclosure. The table requires compensation for each NEO over the last three years, but the rules provide a phase-in for the new disclosures over three years, avoiding the need to recalculate previously-disclosed compensation information. For the 2007 proxy season, companies will be required to provide information about 2006 compensation only.

All Elements of Compensation Covered. Revisions to the Summary Compensation Table are designed to elicit disclosure of all elements of NEO compensation and to include an aggregate number for NEO total compensation. The Summary Compensation Table will require the following information, in separate columns:

- Salary.
- Bonus (now defined to include only bonus payments that are discretionary or guaranteed; performance-based incentive payments are disclosed separately).
- Dollar value of stock awards, based on FAS 123R value on grant date, including the incremental value of any awards that were modified during the year.
- Dollar value for all option awards, based on FAS 123R value on grant date, including the incremental value of any awards that were modified during the year (current rules require disclosure of the number, not value, of option awards).
- Non-equity incentive plan compensation earned during the year, whether or not paid during the year (including bonuses earned under cash incentive plans, such as under a single-year IRC Section 162(m) bonus plan).
- Annual change in actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation.
- Aggregate amount of all other compensation not reported in other columns of the table, including perquisites (discussed in more detail below) that in the aggregate are equal to or greater than $10,000 (compared to $50,000 under current rules) and contributions to defined contribution plans. Any item reported in this column (other than perquisites, which are discussed below) that exceeds $10,000 must be separately identified and quantified in a footnote for the last fiscal year.
- Total compensation, reflecting the sum of all of the other columns in the table for each NEO.

Additional New Requirements. The new rules include many detailed provisions on specific topics, including the following:

- How to account for deferrals of compensation.
- How to handle salary and bonus amounts that cannot be calculated at the most recent practicable date.
- How to distinguish between bonuses and non-equity incentive compensation.

- Required footnote or narrative disclosures with respect to the calculation of the FAS 123R values of equity awards.
- Timing of the disclosure of non-equity incentive plan compensation.
- Treatment of amounts received upon satisfaction of performance measures.
- Calculation of annual change in actuarial present value of accumulated pension benefits and above-market or preferential earnings on deferred compensation.
- Examples of "All Other Compensation" and the very limited types of compensation that are not required to be included.
- Guidance about determining, valuing and disclosing information about perquisites.
- Footnote disclosures required with respect to certain amounts included in the "All Other Compensation" column.
- Guidance about what should be included in the required narrative discussion that is to follow the Summary Compensation Table, including in some cases material terms of employment agreements and an explanation of the amount of salary and bonus in proportion to total compensation.

Practice Tips & Observations: Even where a company does nothing new in 2006 compared to prior years, 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 as required under current rules) and above-market earnings on deferred compensation (even deferred compensation invested in mutual funds) will be included in the table and in total compensation. Moreover, each option grant will be valued at its full FAS 123R value on date of grant, regardless of vesting – so the Summary Compensation Table will reflect in the year of grant the entire amount of compensation expense that is expected to be included in the company's financial statements over the vesting period of the grant. As a result, executive compensation totals will often appear higher than in the past.

Companies will need to evaluate their systems and processes for valuing, gathering and analyzing compensation information for NEOs (part of their disclosure controls and procedures) to ensure that they will be able to produce accurate figures for each of the required columns of the Summary Compensation Table, including the catch-all "All Other Compensation," and to provide any related narrative explanations. This review should include an immediate assessment of which departments and personnel within the company should be responsible for gathering and reviewing the various executive compensation disclosures, as well as updating the company's form of director and officer questionnaire. Companies may also want to begin immediately to prepare tally sheets or a "mock up" of the Summary Compensation Table, as well as the other required tables, since they will want to have plenty of time to finalize the table and circulate it for review and comment by necessary parties, including the compensation committee.

Guidance For Perquisites Disclosure

Principles Used to Determine Perquisites. The final rules contain useful interpretive guidance from the SEC about perquisites disclosure. 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 **not** a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties.
- 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.
- The appropriate way to measure the value of a perquisite is to determine the actual incremental cost to the company of providing the benefit (which generally is different than how perquisites are valued for tax purposes).

Generally, the SEC expects "perquisite or other personal benefits" to be interpreted **broadly**, and "integrally and directly related to the performance of duties" to be interpreted **narrowly**. The SEC suggests that companies approach a perquisite analysis by first evaluating whether the item is integrally and directly related to the performance of the executive's duties. If so, that is the end of the analysis and no perquisite disclosure about the item is required. If not, then companies must assess whether the item confers a personal benefit, and if so, determine the incremental cost of that item.

Examples of Perquisites. Examples of items that **would** require disclosure as perquisites include:

"...club memberships not used exclusively for business entertainment purposes, personal financial or tax advice, personal travel using vehicles owned or leased by the company, personal travel otherwise financed by the company, personal use of other property owned or leased by the company, housing and other living expenses (including but not limited to relocation assistance and payments for the executive or director to stay at his or her personal residence), security provided at a personal residence or during personal travel, commuting expenses (whether or not for the company's convenience or benefit), and discounts on the company's products or services not generally available to employees on a non-discriminatory basis."

By contrast, the following are examples of items that **would not** be perquisites (no required disclosure):

"...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."

The SEC generally believes that companies and their advisors are best suited to determine from the facts of particular situations whether perquisite disclosure is required. The interpretive guidance provided in the release is the SEC's attempt to help companies identify and value perquisites, for disclosure that is required even under current rules. To underscore how seriously it takes perquisite disclosure, the release reminds companies that in the past the SEC has taken enforcement action against companies that did not properly report perquisites.

Specific Disclosures May Be Required. The new rules require that the aggregate amount of perquisites received by NEOs must be included in "All Other Compensation" if that amount is at least $10,000. Footnote disclosures must identify each perquisite included for the last fiscal year, and quantification in the footnote is required for each perquisite paid in the last fiscal year that exceeds the greater of $25,000 or 10% of the total amount of perquisites for that NEO. Where perquisite quantification is required, it must be accompanied by a description of the methodology used to compute aggregate incremental cost to the company.

Practice Tips & Observations: To prepare for the 2007 proxy season, we suggest that companies identify any items that are provided to their NEOs and directors to determine whether they are integrally and directly related to the performance of their duties – and, if not, whether they convey benefits to the NEOs and directors that have a personal aspect. For any items determined to be perquisites, companies should determine how to calculate the "aggregate incremental cost," establish systems to gather the relevant data, and be prepared to disclose this information.

New Tables for Equity and Non-Equity Incentive Awards

Three separate tables address various aspects of equity and non-equity incentive awards under the new compensation disclosure rules.

Grants of Plan-Based Awards. This new table requires the following information about each equity-based award and non-equity incentive award to an NEO during the last fiscal year:

- The estimated dollar value of future payouts upon achievement of performance conditions under non-equity incentive plan awards, or the range of payouts where applicable (note that time-based additional vesting for non-equity incentive awards should be footnoted).
- The grant date for equity awards and, if different than the date the compensation committee or board took action to grant the award, the date of that action;
- The number of shares of stock, or shares underlying stock options, that are to be paid or vested upon satisfaction of performance conditions under equity incentive plan awards (or the range of shares to be paid or vested where applicable);

- The number of shares of stock, or stock options, granted during the year that are not reflected in the table as performance-vested; and

- The per share exercise price of options granted and, if the exercise price is lower than the closing market price on the grant date, an adjoining column with the closing market price on the grant date.

This table will include information about all non-equity incentive awards, regardless of whether they are one-year or multi-year awards. Thus, a cash incentive award payable under an IRC Section 162(m) plan covering only one year will be reported in this table for the year in which the plan is established, and the actual payment will also be reflected in the Summary Compensation Table for that fiscal year if the NEO earns the award.

The table must be supplemented with a narrative discussion of the material factors necessary to an understanding of the information included in the table, including and most importantly, the material terms of the awards reported in the table, such as vesting information and performance criteria. For example, the supplemental narrative could also be used to explain that an award that was earned in the same year appears in both the Summary Compensation Table and the Grants of Plan-Based Awards table.

If the exercise price of an option is not the closing price of the company's stock on the date of grant (regardless of whether it is higher or lower than the closing price), narrative or footnote disclosure must describe the methodology for determining exercise price. For example, if a company uses an average of several trading day closing prices to arrive at the exercise price (i.e., a "formula" plan), that would be disclosed.

Outstanding Equity Awards at Fiscal-Year End Table. This updated table will now show outstanding stock option or other unvested or unearned equity award held by each NEO, including:

- The number of securities underlying exercisable and unexercisable options (including out-of-the money options) on an option-by-option basis.

- Option exercise prices.

- Option expiration dates.

- The aggregate number of unvested or unearned shares or units under stock awards.

- The aggregate market value of unvested or unearned shares or units under stock awards (based upon the closing market price of the company's stock at the end of the last completed fiscal year).

Since this disclosure is now required to include a separate line for each option or other equity award that is held by an NEO, this table may be quite lengthy where one or more NEOs have several outstanding option grants.

Option Exercises and Stock Vested Table. This table will show value that NEOs realized on equity awards during the last fiscal year, whether through the exercise of stock options or vesting of restricted stock (disclosure of which was not previously required). The table will include both the number of shares acquired on exercise of an option or vested on lapse of restrictions, and the value realized on those events based upon the market price of the underlying securities at the time of exercise or vesting less any applicable exercise price. Value is measured and disclosed regardless of whether the shares are held or sold.

Practice Tips & Observations: It is unclear how the table will apply to restricted stock units, since restricted stock units may vest in one year and be paid (and therefore taxable) in a following year.

Pension Benefits and Deferred Compensation Tables

The new rules replace the current table addressing retirement plans with two new tables: the Pension Benefits Table and the Nonqualified Deferred Compensation Table.

Pension Benefits Table. This table will require disclosure of the actuarial present value of each NEO's accumulated benefit under each company pension plan, computed using the same assumptions (except for the normal retirement age) and measurement period as used for financial reporting purposes under GAAP. The table will also disclose the number of years of service credited to the NEO under the plan. The narrative disclosure following the table must include, among other things, a discussion of the valuation method and all material assumptions applied, or a cross-reference to this information appearing elsewhere in the company's financial statements, or Management's Discussion and Analysis.

Nonqualified Deferred Compensation Table. This table will require disclosure with respect to nonqualified deferred compensation plans and executive contributions, company contributions (including contributions reflected in the "All Other Compensation" column of the Summary Compensation Table), withdrawals, all earnings for the year (not just the above-market or preferential portion) and the year-end balance. Footnote disclosure is required to quantify the extent to which amounts in the contributions and earnings columns are reported as compensation in the Summary Compensation Table for the most recent fiscal year, as well as the extent to which other amounts were included in the table for prior years. The narrative disclosure following the table is expected to include additional information about the deferral of, interest on and withdrawals or payments of the compensation reflected in the table.

Practice Tips & Observations: The narrative required as part of the discussion of severance and change of control arrangements (discussed below) will be required to discuss the timing of pension benefit and deferred compensation distributions, including the rationale for the timing of the payments and the form of the distribution.

Severance and Change of Control Arrangements

The new rules require new and detailed narrative disclosure about any contract, plan or arrangement for payments or benefits in connection with NEO termination of employment, NEO change in responsibilities or change in control of the company (no longer limited to payments or benefits exceeding $100,000). In particular, the following must be described and explained:

- The specific circumstances that would trigger payments or benefits.
- The estimated payments and benefits (lump sum, annual or other), including quantification of the amounts, that would be provided in each covered circumstance, the duration of those payments and benefits and the payor or provider.
- How the payment and benefit levels are determined under the various triggers.
- Any material conditions or obligations applicable to the receipt of payments or benefits, including non-compete, non-solicitation, non-disparagement or confidentiality agreements and their duration, and provisions regarding waiver of breach of such agreements.
- Other material factors.

The most significant change in this area is the new requirement that the company *quantify* the specific dollar amounts of payments that may be made to executives upon such a termination or change in control. To make disclosures meaningful and permit comparisons among issuers, the rules assume that the triggering event took place on the last business day of the company's last fiscal year and use the closing price per share of the company's stock on that date to calculate the value of changes in the executives' equity holdings and other benefits. Special rules apply where triggering events actually occur during the year.

The new rules also require discussion of the timing and payment options related to pension payouts and deferred compensation distributions. Where IRC Section 280G gross-up provisions apply, companies will be required to disclose a reasonable estimate (or reasonable range) of the cost of such payments and the assumptions underlying the estimate.

Practice Tips & Observations: Companies that are considering new severance and change in control arrangements in 2006 or later would be well advised to calculate the required hypothetical values of all benefits payable upon the occurrence of a triggering event, including the value of equity awards and any golden parachute payment tax gross-ups. Performing these calculations will enable companies to understand the myriad assumptions associated with such calculations, and to anticipate any issues that might be associated with future disclosures. Companies should also be aware that entering into an agreement that adjusts the treatment of the NEO's equity awards upon a triggering event may constitute a modification of an equity award, requiring additional disclosures (see the discussion in "Summary Compensation Table – Focus on Total Value of Compensation, Including Value of Equity Awards" above).

Companies should also review currently effective severance and change in control arrangements with any NEOs to understand the new disclosures that will need to be made with respect to these arrangements.

Director Compensation Table

Director compensation (including consulting fees and perquisites) for the most recently completed fiscal year will be required to be disclosed in a new table. This "Director Compensation Table" will be similar in format to the Summary Compensation Table and will be accompanied by supplemental narrative disclosures. Footnotes to the tabular disclosures will include aggregate (rather than award-by-award) numbers of stock awards and option awards outstanding at fiscal year end. The related narrative disclosures will include descriptions of standard director compensation arrangements, and whether any director has a different compensation arrangement.

Of particular note is that director legacy and charitable awards programs must now be disclosed in the table, valued at the annual cost of such arrangements, with footnote disclosure of the total dollar amount and other material terms of each such program.

II. GOVERNANCE DISCLOSURE

The new rules add updated and new disclosure requirements about director independence and the operations of the compensation committee, and consolidate existing corporate governance disclosure requirements.

Director Independence

The new director independence disclosures replace disclosure previously required by Item 404(b) of Regulation S-K. The disclosures include the following items:

- Identify each director and nominee who is independent – generally based on the definition of independent director of the exchange on which the company's securities are listed.
- Describe, by specific category or type, any transactions, relationships or arrangements that were considered by the board of directors when determining if applicable independence standards were satisfied, but are not disclosed as a related person transaction.
- Identify any audit committee, nominating committee or compensation committee members who are not independent.

If the company uses a definition of independence for its directors and committee members that is different than that of the exchange upon which it is listed, the company must state whether the definition is posted on its website, and, if not, to include the definition as an appendix to the company's proxy statement at least once every three years.

Practice Tips & Observations: Companies should assess their upcoming director independence disclosures, and their procedures for determining director independence. In addition, companies should ensure that they have the procedures in place to capture information about any potential related person transactions (discussed below) that the board should consider in assessing director independence, so that the company will be able to disclose the categories of these matters that were considered for each director – even if the related person transaction is not required to be disclosed specifically.

Compensation Committee Disclosures

New disclosure about compensation committee processes and procedures related to executive and director compensation will be required, along the lines of disclosure that is currently required about audit and nominating committees. In particular, the company must disclose:

- Whether the compensation committee has a charter, and if so whether it makes the charter available through its website or proxy materials in one of several permissible manners.
- Compensation committee processes and procedures for considering and determining executive and director compensation, including:
- the committee's scope of authority;
- the extent to which the committee may delegate any authority, and if so what authority may be delegated and to whom; and
- any role of executive officers in determining or recommending the amount or form of executive and director compensation.
- The role of any compensation consultants in determining or recommending the amount or form of executive or director compensation, identifying the consultants,

- stating whether the consultants were engaged directly by the compensation committee or by another person, and describing the nature and scope of their assignment and the material elements of instructions given to them with respect to the performance of their duties.

Where a company has no compensation committee, the disclosures would be provided for the persons performing similar functions.

Practice Tips & Observations: To prepare for these new disclosures, the compensation committee should review its charter, delegations of authority and other processes in the coming months, and make any changes that are deemed appropriate. Many companies are already reviewing their policies and practices related to stock option grants. In addition, the company should review its relationships with compensation consultants with a view to future disclosure, including who engaged the consultant, the scope of assignments in 2006 and the material elements of the instructions that were or are being given to the consultant.

Reorganized Corporate Governance Disclosures

In addition to the new disclosures discussed above, the new rules consolidate existing corporate governance disclosure requirements.

- Information about board and committee meetings and board member annual meeting attendance (formerly part of Item 7 of Regulation 14A).
- Information about nominating committees and shareholder communications (formerly part of Item 7 of Regulation 14A and Item 401(j) of Regulation S-K).
- Information about audit committees, including audit committee financial experts and the Audit Committee Report (formerly part of Item 7 of Regulation 14A and Items 306, 401(h) and 401(i) of Regulation S-K).

In addition, the reorganized rules regarding audit committee charters reflect revisions permitting companies to post the charters on their websites, rather than delivering them to security holders, if certain conditions are satisfied.

III. RELATED PERSON TRANSACTION REVIEW AND DISCLOSURE

The new rules update, clarify and somewhat expand existing disclosure requirements for related person transactions, while making the requirements more principles-based. Highlights of the new rules include:

- Requires disclosure of the company's policies and procedures for review, approval or ratification of related person transactions.
- Increased dollar threshold for transactions required to be disclosed, from $60,000 to $120,000.
- Eliminates the separate disclosure requirements for indebtedness and certain business relationships of directors under previous rules, while continuing to require modified disclosure of the substance of both as related person transactions.
- Updates specific exceptions for categories of transactions that do not require related person transaction disclosure.

Approval Procedures

A new requirement of the rules is that companies describe their policies and procedures regarding related person transactions. Some of the features of such a description might include:

- The types of transactions that are covered by the policies and procedures.
- The standards to be applied under those policies.
- The board member or members (or others) who are responsible for applying those policies and procedures.
- Whether the policies are in writing, and how they are evidenced if they are not in writing.

The new rules also require disclosures of gaps in these policies, or failures to apply them consistently. In particular, companies must now disclose where a related person transaction was required to be reported but under the company's policies the transaction did not require review, approval or ratification, or where the policies were not followed.

Practice Tips & Observations: Nasdaq listing standards require that companies 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 for the review of related person transactions. Companies should revisit these policies and procedures to determine whether any changes are appropriate, such as specification of standards to be applied and commitment of policies to writing. Companies should also review their procedures for early identification of potential related person transactions.

Related Person Transaction Disclosures

Related person transaction disclosure is now required for any "transaction":

- Since the beginning of the company's last fiscal year, or that is currently proposed;
- In which the company was or is to be a participant (even if it is not technically a contractual party);
- In an amount exceeding $120,000; and
- In which a "related person" had or will have a direct or indirect material interest.

The rules no longer include the separate category of disclosures for certain relationships between the company and entities with which company directors are affiliated. Formerly, disclosure was required where payments, between the company and businesses with which a director had certain types of relationships (for example, executive officer or 10% shareholder), amounted to more than 5% of either party's revenue. Now any such relationships will be evaluated on the same standards that apply to related party transactions in general.

Consistent with existing disclosure requirements, the period of time for which disclosures must be provided is expanded to three years for various registration statements filed under the Securities Act or Exchange Act.

Scope of Covered Transactions. The term "transaction" is broadly defined to include, among other things, any financial transaction, arrangement or relationship or series of similar transactions, arrangements or relationships, including indebtedness or guarantees. The new related person transaction rules eliminate the separate disclosure requirements for related person indebtedness and now include indebtedness within the general definition of "transaction."

Related Persons. "Related person" includes any person who:

- At any time during the fiscal year was a director or executive officer of the company, or a member of that person's immediate family;
- At any time during the fiscal year was a nominee for director, or a member of his or her immediate family, if disclosure is being included in a proxy statement relating to director elections; and
- At the time the transaction in question occurred or existed was a five percent shareholder or, if applicable, a member of his or her immediate family.

For these executives, directors and nominees (and their immediate family members), disclosure is now required if a related person transaction occurred during any part of the last fiscal year, even if the covered party was not a "related person" at the time of the transaction.

"Immediate family member" is now defined to include a child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and any person (other than a tenant or employee) sharing the household of the indicated person.

Type of Information Required. Descriptions of related person transactions must include:

- The related person's name and relationship to the company.
- The related person's interest in the transaction, including his or her relationship to any person or entity that is a party to or has an interest in the transaction.
- The approximate dollar value of the amount involved in the transaction and of the related person's interest in the transaction.

Exceptions from Disclosure. The new related person disclosure rules contain a number of exceptions from disclosure, including:

- Compensation for an executive officer or director that is reported pursuant to the executive and director compensation disclosure rules.
- Compensation for an executive officer who is not an immediate family member if the compensation would have been reported as compensation for services rendered if the executive was a named executive officer, and the compensation had been approved, or recommended to the company's board of directors for approval, by the company's compensation committee.
- Interests in transactions that arise only from the related person's position as a director of another entity that is a party to the transaction, or from the related person's ownership, together with all other related persons, , of less than a 10% equity interest in another person (other than a partnership) that is a party to the transaction, or both such position and ownership.
- Interests in transactions that arise only from the related person's position as a less than 10% limited partner in a partnership (together with all other related persons), and the person is not a general partner of and does not have another position in the partnership.
- Indebtedness transactions of five percent shareholders and their immediate family members (unless they fit within another category of related persons).
- Interests arising solely from the ownership of a class of equity securities where all holders of that class receive the same benefit on a pro rata basis.

Practice Tips & Observations: Since the new rules change the definitions and disclosure standards about related person transactions, companies should reassess the adequacy of their policies in this area, to ensure that any potential transactions will be analyzed for disclosure issues prior to consummation. Existing transactions and relationships with related persons should be evaluated with the new disclosure standards in mind to determine whether new disclosures will be required. Under the new rules, companies will need to monitor transactions involving the company and any entity where a member of the board of directors is an executive officer, major shareholder or in an equivalent position, to assess whether the amount involved may exceed the $120,000 threshold.

In addition, since the new rules permit disclosure of non-NEO officer compensation to be omitted only if the compensation amounts were approved, or recommended to the board for approval, by the compensation committee, companies should ensure that their officer compensation policies include compensation committee approval (or recommendation to the board for approval) of all elements of officer compensation, consistent with existing Nasdaq governance requirements. Disclosure controls and procedures should be reviewed to ensure they would pick up any non-NEO officer compensation that would have to be reported due to failure to obtain compensation committee approval.

Impact on Rule 16b-3 Non-Employee Directors

Rule 16b-3, which exempts from the Section 16(b) short-swing profit recovery rules certain transactions approved by a Board committee of two or more non-employee directors, refers in part to the related person rules to determine who qualifies as a "non-employee director." As a result, changes made to the related person transaction rules also affect who will qualify as a Rule 16b-3 non-employee director. The SEC has revised the instructions to Rule 16b-3 to specify that, in determining a director's non-employee director status, a company may rely on its related person transaction disclosures for the most recent fiscal year. However, the company must believe in good faith that any current or contemplated transaction in which the director participates will not be required to be disclosed as a related person transaction, based on information readily available to the company and the director at the time the director proposes to act as a non-employee director.

Practice Tips & Observations: Companies should assess whether their non-employee directors continue to meet the requirements of Rule 16b-3, and whether they have procedures that would require analysis of any potential transactions that could change the status of any current non-employee directors, in advance of any action where the company would rely upon those directors for Rule 16b-3 purposes.

IV. FORM 8-K CHANGES

After evaluating the types of agreements filed by public companies following the 2004 amendments to Form 8-K, the SEC observed that some companies filed Forms 8-K to disclose executive compensation arrangements that the SEC believed were not "unquestionably or presumptively material." The SEC has now revised Form 8-K to provide real-time disclosure of employee compensation events that more clearly satisfies this standard. In particular, compensatory arrangements are no longer covered in Form 8-K Item 1.01 (material agreements). Rather, Item 5.02 has been expanded, but only to cover those compensatory arrangements with executive officers and directors that the SEC believes are unquestionably or presumptively material.

Specifically, Form 8-K Item 5.02 covers the following primary additional events and disclosures:

- Retirement, resignation or termination of employment for any person that was an NEO for the company's previous fiscal year, as well as for any principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions, as is currently required.
- Entering into or materially amending any material plan, contract or arrangement in connection with the appointment of a new principal executive officer, president, principal financial officer, principal operating officer or person performing similar functions, where such officer is a party to or participates in the arrangement, or receives any grant or award, or modification of a grant or award, under any such arrangement, in connection with the appointment.
- Entering into or materially amending any material plan, contract or arrangement in connection with the election of a new director, where the director is a party to or participates in the arrangement, or receives any grant or award, or modification, under any such arrangement, in connection with such election.
- Entering into, adopting or commencing, or materially amending or modifying, a material compensatory plan, contract or arrangement in which the company's principal executive officer, principal financial officer or other named executive officer participates or is a party, or a material grant or award to one of those officers (or material modification thereof) under any such plan, contract or arrangement. Grants or awards are not required to be disclosed if they are consistent with previously disclosed terms of the plan and the grant is disclosed the next time the company is required to provide new executive compensation disclosure (*e.g.*, the next proxy statement).

V. OTHER CHANGES

In connection with its executive compensation and related person transaction rulemaking, the SEC modified other disclosure rules, including the following:

- *Pledges of Stock Shown in Security Ownership Table*. The beneficial ownership table will require disclosure of the number of shares that have been pledged by named executive officers, directors and director nominees, and inclusion of any directors' qualifying shares in the total amount of securities owned.

Practice Tips & Observations: In light of these changes, companies should amend their director and officer questionnaires and other information gathering procedures to ensure that they obtain current information about any possible pledges of company stock by named executive officers, directors and nominees. Companies may also wish to revisit any existing policies related to executive officer and director pledges of securities.

- *Performance Graph*. The stock price performance graph has been retained but moved to the portion of the annual report to stockholders that deals with stock price information (Item 201 of Regulation S-K), rather than having it associated with executive compensation. The stock price performance graph will continue to be considered "furnished," not filed.
- *Plain English*. The new rules require companies to prepare most disclosures using plain English principles in organization, language and design. These principles are the same as those that the SEC has applied to some prospectus disclosures in the past.
- *Special Rules for Small Business Issuers and Foreign Private Issuers*. Small business issuers (as defined in Regulation S-B) will be subject to a subset of the new

rules. The new rules also contain exceptions for foreign private issuers.

VI. COMPLIANCE DATES

The SEC adopted the new executive and director compensation rules and the related person transaction and corporate governance rule revisions so that they would be in effect for the 2007 proxy season for calendar year-end companies. Generally speaking, compliance is required for fiscal years ending on or after December 15, 2006.

Specific compliance dates for particular types of filings are as follows:

- For Forms 10-K and 10-KSB, compliance is required for fiscal years ending on or after December 15, 2006;
- For proxy and information statements covering registrants that are not registered investment companies, compliance is required for any proxy or information statements filed on or after December 15, 2006 that are required to include executive compensation or related person transactions disclosures (Items 402 and 404 of Regulation S-K) for fiscal years ending on or after December 15, 2006;
- For registration statements covering registrants that are not registered investment companies, compliance is required for registration statements that are filed with the SEC on or after December 15, 2006 that are required to include executive compensation or related person transactions disclosures (Items 402 and 404 of Regulation S-K) for fiscal years ending on or after December 15, 2006; and
- For proxy and information statements covering registered investment companies, compliance is required for any new proxy or information statement filed on or after December 15, 2006.

Companies will not be required to "restate" compensation disclosure, or related person transaction disclosure, for prior fiscal years where disclosure under the existing rules was already provided. As a result, only the most recent fiscal year will be required to be reflected in the revised Summary Compensation Table when the new rules and amendments become effective. The information for 2004 and 2005 will not have to be presented at all. The additional two years of summary compensation information will phase in over the ensuing two years.

Form 8-K compliance is required for triggering events that occur 60 days or more after publication of the final rules in the Federal Register, which is likely to result in a compliance date in late October of this year.