

ALERT



February 2006

SEC OVERHAULS EXECUTIVE COMPENSATION DISCLOSURE RULES

Key issues to consider for 2006 proxy season

Overview

On 1/27/06, the SEC published proposed rules¹ that completely overhaul the disclosure rules with respect to executive and director compensation (both in terms of persons covered and the compensation disclosed), related party transactions, director independence and other corporate governance matters. If adopted, the proposed rules would represent the first comprehensive revision to the executive compensation disclosure rules since 1992.

The most significant changes resulting from the proposed rules are the addition of a new section for proxy statements entitled Compensation Discussion & Analysis ("CD&A") and a reworked and substantially enhanced Summary Compensation Table ("SCT").

- CD&A will replace the existing Compensation Committee Report and Performance Graph. Analogous to Management's Discussion and Analysis for financial reporting purposes, CD&A will (1) discuss the material factors underlying compensation policies and decisions, (2) discuss the compensation awarded to, earned by or paid to the named executive officers and (3) explain all elements of the company's compensation program. Unlike the current Compensation Committee Report, CD&A would be subject to a stricter liability standard and fall within the scope of the CEO/ CFO certifications filed with the Form 10-K.
- The revamped SCT will fit all elements of compensation (expressed in dollars) into one of six categories and include a "total compensation" column which would be the sum of the six categories. The SCT will be supplemented by (1) a reformatted performance-based award table showing the key provisions of all incentive awards, (2) a series of equity tables, disclosing grants, outstanding awards, exercises of options and vesting of share awards, (3) a new retirement benefits table providing specific information for each named executive officer and (4) a new deferred compensation table reflecting account balances, annual contributions and annual earnings.

While the SEC intends for the new rules to be effective for the 2007 proxy season for calendar year-end companies (or sooner for other filings), it is still important that you consider and understand certain aspects of the proposing release now. In particular, you should consider:

- the interpretative guidance provided in the proposing release for perquisites and other personal benefits ("perks"), and
- how the proposed rules may impact compensation decisions which are currently being made for 2006 and beyond.

This alert only provides a brief summary of these two considerations. A more detailed summary of all of the changes to the disclosure rules for executive and director compensation will be provided in a follow-up alert after the SEC finalizes the rules.

¹ The 370-page proposing release is available at <http://www.sec.gov/rules/proposed/33-8655.pdf>.

2006 Action Items

Guidance on Perk Disclosures. The proposing release contains interpretive guidance on existing rules relating to the disclosure of perks. Thus, you should revisit whether additional items and/or amounts need to be disclosed in the SCT as perks for 2006 in light of this guidance.

The SEC, noting that the concept of perks should not be interpreted artificially narrowly to avoid disclosure, offers the following guidance to consider when assessing whether or not an item is a perk:

- an item is not a perk if it is "integrally and directly" related to the performance of the executive's duties, and
- an item is a perk if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees.

The fact that the company has determined an expense is an "ordinary" or "necessary" business expense for tax or other purposes does not necessarily mean that the item is outside of the perk classification for purposes of SEC disclosure. In addition, business purpose or convenience alone does not affect the characterization of an item as a perk if the item is not integrally and directly related to the performance of the executive's duties. It is important to note that even if an item is dictated by company policy (such as a security policy requiring use of company aircraft for personal travel), it may still be considered a perk.

In the proposing release, the SEC provides several examples of items that might be characterized as perks, and items that are likely integrally and directly related to the performance of the executive's duties (i.e., non-perks).

<u>Perks</u>	<u>Non-Perks</u>
use of company-provided aircraft, yachts or other watercraft	office space at a company business location
club memberships not used exclusively for business entertainment purposes	additional clerical or secretarial services devoted to company matters
personal travel using vehicles owned or leased by the company	reserved parking space that is closer to the business facilities (but otherwise not preferential)
personal use of other property owned or leased by the company	travel to and from business meetings or other business travel
additional clerical or secretarial services devoted to personal matters	security during business travel
security provided at a personal residence or during personal travel	business entertainment
commuter transportation services	itemized expense accounts limited to business purposes
housing and other living expenses (including, among other things, relocation assistance and payments for executive to stay at his or her personal residence)	
personal financial or tax advice; investment management services	
discounts on the company's products or services not generally available to employees on a non-discriminatory basis	

If approved, the proposed rules would reduce the threshold of reportable perquisites from (1) the lesser of \$50,000 or 10% of an executive's annual total salary and bonus to (2) \$10,000. Once the \$10,000 threshold is reached, the proposed rules would require the identification of all perquisites, regardless of value. The proposed rules retain the current standard of reporting compensation on the basis of "incremental cost" to the company, but do not provide additional guidance, particularly as to how to calculate that cost when the business and personal use are not severable.

Ten Items to Consider When Deciding 2006 Compensation. The proposed rules are a significant overhaul of the existing disclosure rules and in many respects will require disclosure of compensation and related matters not historically disclosed in proxy statements. Consequently, companies and their compensation committees should consider with counsel the proposed rules when deciding 2006 compensation as such compensation must be disclosed in next year's proxy statement under the new rules. The following are ten important disclosure and related items to be considered when setting compensation for 2006 and taking other actions related to the 2006 proxy season:

1. **Process Disclosure.** The proposed rules require that companies (including their compensation committees) disclose the role of (a) "executive officers in determining or recommending the amount or form of executive and director compensation" and (b) any compensation consultant, specifying who retained the compensation consultant, describing the instructions and directions given to the compensation consultant and identifying any executive officers who were contacted by the consultant in the performance of its role. In light of the detail required to be disclosed under the proposed rules in next year's proxy statement, companies need to scrutinize the processes and procedures currently in place for determining compensation, and make any appropriate modifications before setting 2006 compensation.

2. **Tally Up.** In addition to the "total compensation" column in the SCT, the proposed rules will also require companies to quantify (based on disclosed assumptions) the amounts payable upon termination of employment and upon a change in control. Companies should consider using tally sheets or what-if models this year to determine how and how much executives are paid to avoid unintended or unexpected disclosures.

3. **Clean Up.** As discussed above, the proposed rules reduce the threshold of reportable perks to \$10,000. Companies should consider updating their record keeping systems and processes in order to track all perks (regardless of value) and consider whether or not to eliminate any perks to avoid potentially "lightning rod" disclosures.

4. **A New Top 5.** The proposed rules change the persons ("NEOs") included in the SCT. Under the proposed rules, the CEO and CFO (regardless of compensation) and the three other most highly compensated executive officers based on "total compensation" for the most recent fiscal year (not just salary and bonus) will be included in the SCT. A result of using total compensation as the determining factor is that large, one-time awards or payments could result in variation among NEOs from year to year. For example, any executive who leaves during the year with a large severance package will likely be included in the following year's SCT because severance payments would be included in the "All Other Compensation" column and, on a total compensation comparison basis, would likely make the executive an NEO. In addition, the proposed rules require a narrative disclosure for up to three additional employees who are not executive officers or directors, but whose total compensation exceeds that of any of the NEOs. Companies should consider what additional processes and procedures are needed in order to track a broader employee base for possible inclusion in the proxy statement.

5. **Inflated Values.** Under the proposed rules, the dollar value of stock and option awards (computed at grant date fair value pursuant to FAS 123R) will be required to be disclosed in the SCT. It is important to understand that, unlike with respect to financial statement reporting, the full grant date value of any award would be reported without regard to subsequent vesting requirements and, therefore, may result in an inflated present day value being reported in the SCT. This may have the effect of unduly highlighting stock-based awards, because cash incentive awards based on non-stock price performance criteria would not be reported in the SCT until the year earned.

6. **Compensation Committee Report.** When drafting the Compensation Committee Report for the 2006 proxy season, consider as a guide the 13 examples of information contained in the proposing release that companies may consider for inclusion in CD&A once adopted. Also, consider including a more detailed discussion of the company's executive compensation policies and programs.

7. **Related Party Transactions.** The proposed rules will require companies to specify the policies and procedures for approval of related party transactions. If your company does not currently have such written policies and procedures, you may wish to adopt them soon.

8. **Non-Employee Director?** Carefully consider any potential related party transactions (regardless of value) between the company and any current or prospective compensation committee member (including immediate family members). Until the proposed rules are finalized, the determination of who is a "non-employee director" for purposes of Rule 16b-3² may not be clear due to the migration away from specific tests to a judgment-based "principled" approach.

9. **Pledged Stock.** The proposed rules will require a foot-note to the beneficial ownership table that discloses the number of shares of company stock that are pledged as security by NEOs, directors, director nominees and all directors and executive officers as a group.

2 Rule 16b-3 under the Exchange Act of 1934 exempts transactions in a company's securities between the company and its officers and directors from Section 16(b) short-swing liability if certain conditions are met, e.g., pre-approval of transaction by a board committee composed solely of two or more "non-employee directors."

Given that such pledges could affect management decision-making and/or result in sales of insider stock at non-opportune times, consideration should be given as to whether such pledges should be prohibited as part of the company's insider trading policy. In addition, companies should begin to establish a process to collect information about share pledges made by officers and directors.

10. Independence Rules. The proposed rules (as well as similar rules currently proposed by the NYSE) will require a company to describe any transactions, relationships or arrangements that its board considered in determining each director's independence. Companies may want to adopt (or review if all ready adopted) independence guidelines to assure that their guidelines are clear regarding the types of transactions, relationships and arrangements that will and will not be considered in the independence determination.

Other Items to Consider for 2006 Proxy Statement.

1. Director Compensation. Another proposal that should be relatively easy to implement (in part) for the 2006 proxy season is tabular disclosure of director compensation similar to the SCT for executive officers. Among other items, the proposed table will require disclosure of total compensation, perquisites, consulting fees and awards under director legacy and similar charitable awards programs. Narrative disclosure will describe any material factors necessary to an understanding of the table, including, for example, a breakdown of types of fees.

2. Plain English. The new disclosure regime will generally require compensation disclosure to be in "plain English." As you prepare your company's proxy materials this season, you may want to consider using various plain English standards, such as:

- using short, concise sections, paragraphs and sentences;
- including tables, charts and bullet-point lists to describe complex material; and
- using the active voice and avoiding multiple negatives.

Timing and Transition of Final Rules

The SEC is accepting written comments on the proposed rules until 4/10/06, after which there is likely to be a deliberation period of several months. When the final rules are adopted, they are expected to apply with respect to proxy statements that are filed 90 days or more after the publication of the final rules. Accordingly, it appears likely that 6/30 (or earlier) fiscal year-end companies will not be required to comply with the new rules this proxy season. However, barring any unforeseen delays, it is possible that the new rules may apply to companies with a 9/30 fiscal year-end.

The new rules would be phased in on a going-forward basis and would not require companies to restate disclosure relating to prior fiscal years, e.g., the new SCT would include only one fiscal year's compensation information for the first year the new rules are effective. An additional year of disclosure would be included over each of the next two years, until three full fiscal years are presented (as is currently the case).

Should you have any questions about the matters addressed in this Alert, please contact the following Kirkland & Ellis author or the Kirkland & Ellis attorney you normally contact.

Robert M. Hayward
rhayward@kirkland.com
(312) 861-2133

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to Rules 7.2 to 7.4 of the Illinois

Rules of Professional Conduct, this publication may constitute advertising material.

Copyright © 2006 KIRKLAND & ELLIS LLP. All rights reserved.

www.kirkland.com