KIRKLAND & ELLIS LLP

ALERT

January 2007

SEC RELEASES INTERIM FINAL RULES REGARDING REPORTING AND DISCLOSURE OF EQUITY AWARDS TO NAMED EXECUTIVE OFFICERS AND DIRECTORS

In what has been described in some quarters as an early Christmas present to public companies, the Securities and Exchange Commission (the *"SEC"*) unexpectedly released interim final rules (the *"New Rules"*) on December 22, 2006 that significantly change the reporting and disclosure of equity-based awards to named executive officers (*"NEOs"*) and directors. The New Rules are effective immediately, meaning that proxy statements required to be filed after their release must incorporate the newly adopted changes.

Although there has been a certain amount of unfavorable public commentary on the New Rules, it is fair to say that the New Rules provide more information to investors in a clearer manner without eliminating any material information that was required to be provided prior to their adoption.

Brief Summary of Changes

Under the rules adopted by the SEC on July 26, 2006 (the *"Current Rules"*), reporting companies were required to include in the Summary Compensation Table the full fair value, determined as of the grant date, of equity awards made to NEOs and directors in the relevant year, regardless of the period over which these awards vest and are earned by NEOs or directors. Since the adoption of the Current Rules, the SEC has been persuaded that this mode of reporting does not provide a clear or complete picture of the compensation actually earned by NEOs and directors during the reported year. The New Rules are intended to rectify these perceived failings by making the following changes in the reporting and disclosure of equity-based awards:

- <u>Changes to Summary Compensation Table</u>. Instead of including the full grant date fair value of equity awards made in the relevant year, the Stock Awards and Option Awards columns in the Summary Compensation Table are to include, with the nuances described below, the amount required to be included with respect to each NEO in the reporting company's financial statements under Financial Accounting Standard 123R (*"FAS 123R"*) for that year. Therefore, if the "service period" (which is generally the award's vesting period) of equity awards (including equity awards made in prior years) extends into 2006 or later years, the portion of the award treated as an expense under FAS 123R in the relevant year would be included in the Summary Compensation Table for that year.

  In calculating the amount to be included in the Summary Compensation Table for equity grants, the New Rules include two important caveats. First, reporting companies are required to assume that NEOs will fully earn all equity awards that are subject solely to time-based vesting conditions. That is, the New Rules prohibit use of the "discount" employed under FAS 123R to determine the value of time-vested equity awards. Second, the value of awards subject to performance-based vesting conditions is to be included in the Summary Compensation Table only when, and if, it becomes "probable" that such awards will be earned. In either case, the value of awards previously included in the Summary Compensation Table is to be "reversed" (i.e., subtracted from the compensation otherwise payable to a NEO) in any later reporting year in which the awards are subsequently forfeited.

- Changes to Grants of Plan-Based Awards Table. The New Rules modify the Grants of Plan-Based Awards Table by requiring (i) the disclosure of equity grants to NEOs during the applicable year on a grant-by-grant basis, (ii) the disclosure of the full grant date fair value of each equity grant made to NEOs during the applicable year, computed in accordance with FAS 123R, and (iii) the disclosure on a grant- by-grant basis of the incremental fair value of option-like awards that have been re-priced or materially modified, as computed inaccordance with FAS 123R. In other words, the New Rules still require the disclosure of the full grant date fair value of equity awards made to NEOs, but this information is required to be included in the Grants of Plan Based Awards Table rather than in the Summary Compensation Table.

- Corresponding Changes for Equity Awards to Directors. The New Rules revise the reporting and disclosure of equity awards to directors to track the principles embodied in the rules applicable to NEOs, although the presentation of this information is slightly different from that required for NEOs.

Significance of Changes

The changes implemented by the New Rules will be significant to reporting companies for several reasons:

- First, the New Rules will require reporting companies to collect additional information in order to file proxy statements. As noted earlier, the amount required to be included in the Summary Compensation Table is, essentially, the amount required to be recorded in the reporting company's financial statements under FAS 123R. This means that most reporting companies will be required to include in the Summary Compensation Table amounts for awards granted prior to the relevant year shown in the proxy statement, including grants made prior to 2006, if the "service period" of these grants extends into the relevant year.

- Second, reporting companies will have some flexibility under the New Rules in fixing, at least for the year of grant, the amount of compensation reported in the Stock Awards and Option Awards columns of the Summary Compensation Table for that year. Awards made later in the year will usually have lower value ascribed to them in the Summary Compensation Table, and awards that are subject to performance conditions the achievement of which is not "probable" may not be reported at all in the Summary Compensation Table. Therefore, the amount recorded in the Summary Compensation Table for a particular year could be reduced by granting time-vested awards later in the year or by imposing tough performance conditions on the vesting of equity awards. Amounts that are not reported in the year of grant, however, will ultimately be reported in later years unless the awards are forfeited.

- Third, because the New Rules tie the information required to be reported in the Summary Compensation Table so firmly to the amounts required to be recognized in the reporting companies' financial statements under FAS 123R, reporting companies will likely need to coordinate even more closely with their outside accountants in preparing annual proxy statements.

- Finally, the New Rules may affect the identification of reporting companies' NEOs. Because NEOs (other than the principal executive and financial officers) are determined, in part, on the compensation includible on the Summary

Compensation Table, the change in the manner in which the value of equity awards are disclosed may result in different executive officers being identified as NEOs. For instance, under the Current Rules the one-time grant of a large equity award vesting over several years could, virtually by itself, cause an executive officer to be identified as a NEO for the year of grant. Under the New Rules, it is less likely that one-time or off-cycle grants would in and of themselves cause an executive officer to be considered to be a NEO.

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

Scott D. Price	Carter W. Emerson	R. Scott Falk	Robert M. Hayward
(212) 446-4851	(312) 861-2052	(312) 861-2340	(312) 861-2133
sprice@kirkland.com	cemerson@kirkland.com	sfalk@kirkland.com	rhayward@kirkland.com