K&LNG Alert

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Executive Compensation/Securities

The SEC's New Executive and Director Compensation and Related Party Disclosure Rules: A Guide for Companies and Compensation Committees

At an open meeting held on July 26, 2006, the Securities and Exchange Commission (SEC) adopted sweeping changes to its disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters, and security ownership of officers and directors. The SEC issued the new rules after considering the over 20,000 comments it received on the proposed rules that were issued by the SEC on January 27, 2006. The adopting release containing the final rules (Adopting Release) is a massive 436-page document. The Adopting Release was issued on August 11, 2006 and can be found by clicking here. This Alert summarizes the final rules in a question and answer format and provides suggested compliance guidelines and procedures to assist companies and their compensation committees in complying with the new requirements. K&LNG is issuing a separate Alert addressing the provisions of the Adopting Release relating to changes in the disclosure of new or modified executive compensation arrangements under the Form 8-K reporting requirements, which have an earlier effective date than the other provisions of the Adopting Release.

Executive and Director Compensation Disclosure

What approach to the disclosure of executive compensation programs and practices has the SEC taken in the final rules?

SEC Chairman Cox has repeatedly emphasized that it is not the SEC's role to judge whether particular executive compensation packages are "right" or "fair" or to place limits on executive compensation. The fundamental objective of the SEC's new disclosure rules is to clarify and demystify compensation and make it intelligible to the lay reader. By making pay practices transparent, it is hoped that compensation committees and shareholders will have the information they need to better monitor and regulate companies' executive pay practices.

The final rules provide that all elements of compensation must be disclosed. The two foundational components of the new rules are (1) the Compensation Discussion & Analysis (CD&A) section in which the company is to describe, in narrative form, the material factors underlying the company's compensation policies and decisions, and (2) tabular disclosure in three broad categories: (a) compensation with respect to the last fiscal year (and the two preceding fiscal years), as reflected in a Summary Compensation Table (SCT), and supplemented by a table providing certain backup information, (b) holdings of equity-related interests that relate to compensation or are potential sources of future gains, and (c) retirement and other post-employment compensation.

How do the final rules differ from the rules as initially proposed by the SEC?

The SEC adopted the rules substantially as proposed but with a number of modifications. The key changes are as follows:

- Detailed disclosure will be required with respect to the company's stock option grant practices and procedures, particularly regarding the timing of option grants and the manner in which the exercise price of options is determined.
- Some types of payments reported in the SCT as "Bonus" under the prior rules will now be reportable as "Non-Equity Incentive Plan Compensation."

- Changes in pension values and earnings on deferred compensation plans will not be included in the "Total Compensation" column of the SCT and will not be taken into account in determining which executives are to be included in the SCT.
- Under the proposed rules, the SCT would have been required to include all earnings on deferred compensation for each of the persons included in the tables. The final rules require the inclusion only of above-market or preferential deferred compensation earnings.
- The final rules reinstate a requirement for a Compensation Committee Report, over the names of the individual members of the compensation committee, that will consist simply of a short statement with regard to the committee's review of and recommendation with respect to the CD&A.
- The final rules also reinstate the requirement of a Performance Graph, but provide that it will be included in the annual report to security holders issued in connection with annual meetings at which directors are to be elected rather than as part of the executive compensation disclosure.
- The so-called "Katie Couric" rule is eliminated. This proposed rule would have required the company to include in the SCT up to three additional individuals whose total compensation was greater than that of any of the other individuals includable in the tables but who were not executive officers of the company during the last completed fiscal year. A modified, substantially narrowed version of this rule will be reproposed for public comment.

When do the final rules become effective?

The new rules will be phased in over a three-year period. Filings required to include executive compensation disclosure and disclosure required by Item 404 of Regulation S-K that are made after December 15, 2006 will have to apply the new rules with respect to fiscal years ending after December 15, 2006. The company will not be required to restate its compensation data for prior years to comply with the new rules.

Which executives of the company must be included in the tabular and narrative disclosure of executive compensation?

The company's named executive officers (NEOs) whose compensation must be disclosed are (1) each person who served at any time during the last completed fiscal year as the company's principal executive officer or principal financial officer, (2) the three individuals who were executive officers of the company as of the last day of the most recent fiscal year and whose total compensation for such fiscal year was the highest, and (3) up to two other persons who served as executive officers of the company during such year and whose total compensation would have placed them among the three other highest paid executive officers but for the fact that they were not executive officers of the company as of the last day of the fiscal year. For this purpose, "total compensation" includes all compensation disclosed in the SCT except for the increase in the actuarial value of pension benefits and earnings on deferred compensation accounts. Only executives whose total compensation exceeds $100,000 are required to be included.

Under the proposed rules, the accompanying narrative would have required disclosure for up to three employees who were not executive officers during the last completed fiscal year, but whose total compensation was greater than that of any of the NEOs. This provision will be revised and re-proposed for public comment. The new proposal will be similar to the original proposal except that it will exclude employees having no responsibility for significant policy decisions within the company, a significant subsidiary, or a principal business unit, division or function. This requirement would only apply to large accelerated filers.

What are the new rules on disclosure of the company's stock option grant practices?

Following the issuance of the proposed rules at the beginning of 2006, the backdating of stock options and similar practices became a widely-publicized controversy. In response, the SEC included in the final rules provisions designed to ferret out backdating and other potentially manipulative option practices. The significance of the backdating issue to the SEC is highlighted by the fact that a discussion of the stock option disclosure rules is placed at the very front of the Adopting Release. According to the SEC, it is not the purpose of these rules to discourage the use of stock options or prohibit any particular option grant practices but only to require appropriate disclosure of such practices, whatever they may be.

Companies will have to provide certain tabular and narrative disclosure about option grants and the company's option grant policies and procedures, including the timing of option grants in relation to the public disclosure of material information, positive or negative, about the company. The tabular disclosure with respect to option grants will be required to include:

- The grant date fair value of options granted during the fiscal year, as determined under Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123-R);
- A separate table providing disclosure of equity awards, including the grant date as determined pursuant to FAS 123-R (generally the day the decision is made to award the option as long as recipients of the award are notified promptly);
- The closing market price of the stock on the grant date if it is greater than the exercise price of the option; and
- The date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date.

If the exercise price of an option is not the grant date closing market price per share, the disclosure must include a description of the methodology used for determining the exercise price.

Additional narrative discussion will be required in the CD&A section of the disclosure with respect to the reasons the company selects particular grant dates for awards and the methods the company uses to select the exercise prices and other terms of stock options. The company will be required to address the following questions with regard to option grant timing:

- Does the company have a program, plan or practice to time option grants to its executives in coordination with the release of material nonpublic information?
- How does any program, plan or practice to time option grants to executives compare to the company's program, plan or practice, if any, with regard to option grants to employees more generally?
- What was the role of the compensation committee in approving and administering such a program, plan or practice and how did the board or compensation committee take the timing of disclosure of material nonpublic information into account when determining whether and in what amount to make those grants?
- Did the compensation committee delegate any aspect of the actual administration of a program, plan or practice to any other persons?
- What was the role of executive officers in the company's 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 nonpublic information?
- Does the company plan to time, or has it timed, its release of material nonpublic information for the purpose of affecting the value of executive compensation?

Similar requirements will apply if the company has a program, plan or practice of setting option exercise prices based on the stock's price on a date other than the actual grant date or if exercise prices are set using formulas based on average prices (or lowest prices) during a specified period.

K&LNG's detailed Alert on the option backdating issue can be found by clicking here.

What is the purpose of the Compensation Discussion and Analysis (CD&A) and what information is required in the CD&A and the new Compensation Committee Report?

The required executive compensation disclosure will begin with the CD&A, a narrative providing a general overview of executive compensation policies, programs and practices of the company. Analogous to the MD&A relating to the company's business and financial condition, the CD&A is a discussion and analysis of the components of pay for the company's NEOs and the material factors underlying the company's compensation policies and decisions.

The SEC refers to the CD&A requirement as being "principles-based," in that the final rules identify the disclosure concept and provide several illustrative examples, but do not provide a blueprint or approved model for the CD&A. Each company must then determine how the principles reflected in a particular example apply to its circumstances. In general, the CD&A must discuss (1) the objectives of the company's compensation programs, (2) the outcomes

the compensation program is designed to reward, (3) each element of compensation, (4) why the company chooses to pay each element of compensation, (5) how the company determines the amount (and, where applicable, the formula) for each element of compensation, and (6) how each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements.

The CD&A is to address important aspects of compensation for the last fiscal year, and may also include discussion of policies and arrangements that will be applicable in the future. It should also cover executive compensation actions that were taken after the last fiscal year's end, and it may be necessary to discuss prior years in order to give context to the disclosure provided. If policies or decisions for a particular NEO, such as the principal executive officer, are materially different than those of others, that NEO's compensation should be discussed separately. As noted above, a company's policies, programs and practices regarding the award of stock options and other equity-based instruments to compensate executives may have to be discussed in the CD&A.

The final rules also include a list of fifteen examples of the issues that would potentially be appropriate for the company to address in its CD&A. The application of each example must be tailored to the particular company. The list of examples is not exclusive. Each company must assess the materiality to investors of the information that is identified by the example in light of the particular situation of the company. Some examples may not be material to a particular company, and in that case no disclosure would be required in response to those examples. The examples are as follows:

- The policies for allocating between long-term and currently paid out compensation;
- The policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- For long-term compensation, the basis for allocating compensation to each different form of award (such as relationship of the award to the achievement of the registrant's long-term goals, management's exposure to downside equity performance risk, correlation between cost to registrant and expected benefits to the company);
- How the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
- What specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- How specific forms of compensation are structured and implemented to reflect these items of the registrant's performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goals or to reduce or increase the size of any award or payout), identifying any particular exercise of discretion, and stating whether it applied to one or more specified NEOs or to all compensation subject to the relevant performance goals;
- How specific forms of compensation are structured and implemented to reflect the NEO's individual performance and/or individual contribution to these items of the registrant's performance, describing the elements of individual performance and/or contribution that are taken into account;
- Company policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment;
- The factors considered in decisions to increase or decrease compensation materially;
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (*e.g.*, how gains from prior option or stock awards are considered in setting retirement benefits);
- With respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payment at, following, or in connection with any termination or change-in-control, the basis for selecting particular events as triggering payment (*e.g.*, the rationale for providing a single trigger for payment in the event of a change in control);

- The impact of the accounting and tax treatments of the particular form of compensation (including but not limited to tax code Section 162(m) and tax consequences to the NEOs and to the company);
- The company's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging the economic risk of such ownership;
- Whether the registrant engaged in any benchmarking of total compensation, or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- The role of executive officers in determining executive compensation.

Companies are not required to disclose specific target levels with respect to quantitative or qualitative performance factors considered in setting executive pay, but they will have to disclose the performance factors themselves unless they can satisfy the burden of proving that the factors involve confidential commercial or financial information, the disclosure of which would have an adverse effect on the company. The standard applicable when determining if disclosure would have an adverse effect on the company is the same one that applies when companies request confidential treatment of information for purposes of other SEC disclosure rules. If a performance target has otherwise been disclosed publicly, disclosure in the CD&A could not be avoided under this exception. Further, if performance targets are not disclosed in reliance on this exception, the company must discuss how difficult it will be for the executive or how likely it will be for the company to achieve the undisclosed target levels or other factors, and if the SEC or its staff reviews the disclosure, the company may be required to demonstrate that the exclusion was warranted, and to disclose the information if the SEC or its staff determines that the standards applicable to the exception are not met.

The final rules reinstate a requirement for a Compensation Committee Report to be presented over the names of the individual members of the compensation committee. This report will consist solely of a statement of whether the compensation committee has reviewed and discussed the CD&A with management and, based on this review and discussion, recommended that it be included in the company's annual report on Form 10-K and proxy statement.

What is the legal status of the CD&A and the Compensation Committee Report?

The CD&A will be considered "filed" with the SEC. Therefore, it will be subject to Regulations 14A or 14C and to the liabilities of Section 18 of the Securities Exchange Act of 1934, as amended (Exchange Act). In addition, to the extent that the CD&A (and any of the other disclosure regarding executive officer and director compensation) is included or incorporated by reference into a periodic report, the disclosure would be covered by the certifications that principal executive officers and principal financial officers are required to make under the Sarbanes-Oxley Act of 2002 (SOX).

Unlike its predecessor under the prior rules, the old Compensation Committee Report, the CD&A is a "company document." The CD&A is not deemed authored or furnished by or the responsibility of the compensation committee. By contrast, the Compensation Committee Report will be treated as "furnished", not "filed." In certifying the information contained in the "filed" CD&A, the company's principal executive officer and principal financial officer are permitted to rely on the "furnished" Compensation Committee Report.

What are the requirements for tabular and supplemental narrative disclosure of executive compensation?

The required compensation disclosure consists of six tables, with supplemental narrative disclosure explaining the information in the tables, and narrative disclosure regarding severance and other post-employment benefits. The required tables are as follows:

THE SUMMARY COMPENSATION TABLE

The SCT reports the compensation of each NEO over the last three completed fiscal years whether or not actually paid out. The SCT will include the following columns:

- ***Salary***
  This column is largely unchanged from the prior rules. Deferred salary must be included in the column and quantified in a footnote. A similar

rule applies to the deferral of compensation reportable in any other column of the SCT.

- ***Bonus***
  A significant change has been made to the bonus column. Under the prior rules, companies typically reported in this column compensation under almost all cash-based "annual performance plans." Under the new rules, the bonus column will include compensation under performance-based cash plans only if earned upon satisfaction of a performance target that was not pre-established and communicated to the executive or if the outcome was not substantially uncertain. Incentive plan compensation not reportable in the bonus column will be reportable in the SCT as non-equity incentive plan compensation.
- ***Stock Awards***
  This column discloses the dollar value of stock-related awards that derive their value from the company's equity securities or permit settlement by issuance of the company's equity securities, such as restricted stock, restricted or phantom stock units and other similar instruments that do not have option-like features. The value of such awards is measured by the grant date fair value, computed under FAS 123-R.
- ***Option Awards***
  This column shows the dollar value for all stock options, stock appreciation rights (SARs) and similar stock-based compensation instruments that have option-like features, measured by the grant date fair value, computed under FAS 123-R. If options are repriced, only the incremental fair value must be reported. The assumptions underlying such fair value calculations must be set forth in a footnote referencing the discussion of them in the notes to the company's financial statements or the discussion of relevant assumptions in the company's MD&A. It is important to note that for both stock and option awards, the full grant date fair value must be reported in the SCT even though for accounting purposes the cost of the award may be spread over the vesting period of the award. This rule will have the effect of skewing the reported compensation of any executive who receives a large grant in a particular year. The Adopting Release states that if a company does not believe that the full grant date fair value of stock or option awards reflects compensation earned, awarded or paid during a fiscal year, it can provide appropriate explanatory disclosure in the accompanying narrative section.
- ***Non-Equity Incentive Plan Compensation***
  This column reports the dollar value of all incentive plan awards not reported in the stock awards or option awards columns, *e.g.*, compensation under a cash performance plan based on financial measures other than stock value. Earnings on outstanding non-equity incentive plan awards are also included in this column and identified and quantified in a footnote. Such compensation is reported in the year when the relevant specified performance criteria are satisfied and the compensation is earned, whether payment is actually made in that year or is deferred to a later year. In other words, unlike equity incentive plan awards, which are reported based on grant date value when awarded, non-equity incentive plan awards are reported when earned. The term "earned" is used loosely (if not misleadingly) here, as the Adopting Release indicates that awards for which the relevant performance condition has been satisfied must be reported even if they remain subject to forfeiture conditions (such as conditions requiring continued service or conditions that provide for forfeiture based on future company performance). The confusion which this approach will likely engender (treating as "earned" an amount that has not yet really been earned) will have to be addressed in a footnote or the narrative disclosure accompanying the SCT.
- ***Change in Pension Value and Nonqualified Deferred Compensation Earnings***
  This column reports the annual change in the actuarial present value of accumulated pension benefits under each retirement plan, including tax-qualified defined benefit plans and supplemental employee retirement plans (SERPs), but excluding 401(k) and other defined contribution plans. The change is to be calculated from the pension plan measurement date used for the company's audited financial statements for the prior completed fiscal year to the pension plan measurement date used for the company's audited financial statements for the covered fiscal year. Footnote identification and quantification of the full amount of each

element is required. In addition, this column must include above-market or preferential earnings on nonqualified deferred compensation. The above-market or preferential portion is determined for interest by reference to 120% of the applicable federal long-term rate and for dividends by reference to the dividend rate on the company's common stock.

- ***All Other Compensation***
  This column shows the aggregate amount of all other compensation not reported in the other columns of the table. Each item of compensation included in this column, except for perquisites which are addressed in the next Q&A, that exceeds $10,000 must be separately identified and quantified in a footnote. This column includes the following items:
  - perquisites (the next Q&A below addresses the guidance the SEC has provided to assist companies in identifying and determining the reporting value of perquisites);
  - amounts paid or accrued pursuant to a plan or arrangement in connection with any termination (or constructive termination) of employment or a change in control;
  - annual company contributions or other allocations to vested and unvested defined contribution plans;
  - any earnings on stock awards or option awards that are not included in the grant date fair value computation for those awards;
  - the dollar value of any insurance premiums paid by the company with respect to life insurance for the benefit of an NEO;
  - "gross-ups" or other amounts reimbursed during the fiscal year for the payment of taxes; and
  - the compensation cost computed in accordance with FAS 123-R for any company security purchased from the company or its subsidiaries at a discount from the market price of such security at the date of purchase, unless that discount is available generally either to all security holders or to all salaried employees of the company.
- ***Total Compensation***
  In this column, the total of the compensation shown in each of the columns will be shown.

GRANTS OF PLAN-BASED AWARDS TABLE

This table supplements the SCT and will be accompanied by narrative disclosure that will help explain the compensation information presented in the table. The table will include the terms of grants made during the current year, on a grant-by-grant basis, including estimated future payouts for both equity incentive plans and non-equity incentive plans. The table must also show the FAS 123-R grant date of options, the closing price of the stock on the grant date if greater than the option exercise price, and the date on which the compensation committee or board took action to grant the award if different than the grant date. If the exercise price of an option is not the grant date closing market price per share, a footnote or the accompanying narrative must describe the methodology for determining the exercise price.

Following the SCT and the Grants of Plan-Based Awards Table, narrative disclosure is required to give context to the information in the tables. The narrative must discuss any additional material factors necessary to an understanding of the information disclosed in the tables. The material factors may, for example, include descriptions of the material terms in the NEOs' employment agreements that may have a bearing on the tabular information. Other material factors may include information about the repricing, extension of exercise periods, change of vesting or forfeiture conditions, change or elimination of applicable performance criteria, change of the bases upon which returns are determined, or any other material modification of options or other equity-based awards during the last fiscal year.

The narrative will also describe, to the extent material and necessary to an understanding of the tabular disclosure, award terms relating to information provided in the Grants of Plan-Based Awards Table. This could include, for example, a general description of the formula or criteria to be applied in determining the amounts payable, the vesting schedule, a description of the performance-based conditions and any other material conditions applicable to the award.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR END TABLE

This table will show information regarding outstanding awards under stock option, SAR, restricted stock incentive and similar plans, including such information as the amount of securities underlying exercisable and unexercisable options, the exercise prices and the expiration dates for each outstanding option (rather than on an aggregate basis). The table also discloses the numbers and market values of nonvested stock and equity incentive plan awards.

THE OPTION EXERCISES AND STOCK VESTED TABLE

This table will show the amounts received upon exercise of options or similar instruments or the vesting of stock or similar instruments during the most recent fiscal year.

THE PENSION BENEFITS TABLE

This table will require disclosure of the actuarial present value of each NEO's accumulated benefit under each pension plan and the number of years of service credited to each NEO under the plan, computed using the same assumptions (except for the normal retirement age) and measurement period as used for financial reporting purposes under generally accepted accounting principles. A separate line of tabular disclosure is required for each plan in which an NEO participates that provides for the payment of specified retirement benefits, or benefits that will be paid primarily following retirement. Benefit calculations should reflect the current compensation of the NEOs. "Normal retirement age" means the normal retirement age defined in the plan, or if not so defined, the earliest time at which a participant may retire under the plan without any benefit reduction due to age. The table also shows the amount of any pension benefits paid to an NEO during the last completed fiscal year.

Narrative accompanying the table must describe any material factors necessary to an understanding of each plan disclosed in the table. Examples of such factors may include: the material terms and conditions of benefits available under the plan, including the plan's retirement benefit formula and eligibility standards, and early retirement arrangements; the specific elements of compensation, such as salary and various forms of bonus, included in applying the benefit formula, identifying each such element; regarding participation in multiple plans, the different purposes for each plan; and company policies with regard to such matters as granting extra years of credited service.

THE NONQUALIFIED DEFERRED COMPENSATION TABLE

This table will require disclosure with respect to nonqualified deferred compensation plans of amounts of executive contributions, company contributions, withdrawals, all earnings for the year (not just the above-market or preferential portion) and the year-end balance. To avoid double counting, the company must quantify in a footnote the extent to which (1) amounts in the contributions and earnings columns are reported as compensation in the year in question, and (2) other amounts reported in the table in the aggregate balance column were reported previously in the SCT for prior years. The table would be followed by a narrative description of material factors necessary to an understanding of the disclosure in the table. Examples of such factors include: the type(s) of compensation permitted to be deferred, and any limitations (by percentage of compensation or otherwise) on the extent to which deferral is permitted; the measures of calculating interest or other plan earnings (including whether such measures are selected by the NEO or the company and the frequency and manner in which such selections may be changed); quantifying interest rates and other earnings measures applicable during the company's last fiscal year; and the material terms with respect to payouts, withdrawals and other distributions.

NARRATIVE DISCLOSURE CONCERNING TERMINATION AND CHANGE IN CONTROL PAYMENTS

The company will have to provide a narrative description of any arrangement that provides for payments or benefits at, following, or in connection with any termination of an NEO, a change in responsibilities, or a change in control of the company, including quantification of these potential payments and benefits assuming that the triggering event took place on the last business day of the company's last fiscal year and the price per share was the closing market price on that date. The narrative

must include the following information regarding termination and change in control provisions:

- the specific circumstances that would trigger payment under the termination or change in control arrangements or the provision of other benefits (references to benefits include perquisites);
- the estimated payments and benefits that would be provided in each termination circumstance, and whether they would or could be lump-sum or annual, disclosing the duration and by whom they would be provided;
- the specific factors used to determine the appropriate payment and benefit levels under the various circumstances that would trigger payments or provision of benefits;
- any material conditions or obligations applicable to the receipt of payments or benefits, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality covenants; and
- any other material features necessary for an understanding of the provisions.

The item contemplates disclosure of the duration of non-compete and similar agreements, and provisions regarding waiver of breach of these agreements, and disclosure of tax gross-up payments. A company is required to provide quantitative disclosure under these requirements even where uncertainties exist as to amounts payable under these plans and arrangements. In the event that uncertainties exist as to the provision of payments or benefits or the amounts involved, the company would be required to make reasonable estimates and disclose material assumptions underlying such estimates in its disclosure. In such event, the disclosure would be considered forward-looking information as appropriate that falls within the safe harbor for disclosure of such information.

WHAT ARE THE NEW RULES ON THE REPORTING OF PERQUISITES?

Perquisites and other personal benefits must be disclosed in the "Other Compensation" column of the SCT unless the aggregate amount of such compensation is less than $10,000. A footnote must identify each perquisite or other personal benefit and, if it is valued at the greater of $25,000 or ten percent of total perquisites and other personal benefits, its value must be disclosed. The proper measure of value of perquisites and other personal benefits is the aggregate incremental cost to the company. The methodology for computing the aggregate incremental cost for the perquisites must be disclosed in a footnote.

There is no comprehensive definition of or bright line test for identifying perquisites. Among the factors to be considered in determining whether an item is a perquisite or other personal benefit are the following:

- Is an item integrally and directly related to the performance of the executive's duties? If the answer is "yes," the item is not a perquisite or personal benefit. If the answer is "no," then the next question must be considered.
- Does the item confer a direct or indirect benefit that has a personal aspect that is not generally available on a non-discriminatory basis to all employees? If the answer is "yes," the item is a perquisite or personal benefit. If the answer is "no," the item is not a perquisite or personal benefit.

The Adopting Release indicates that the concept of a benefit that is "integrally and directly related" to job performance is a narrow one that captures only items that a company provides because the executive needs them to do the job. The fact that an item has a business purpose or convenience is not sufficient to avoid the characterization of an item as a perquisite or personal benefit where the "integrally and directly related" test is not met.

The Adopting Release provides the following non-exclusive list of examples of items that are considered perquisites or personal benefits under the final rules: 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.

What are the new rules regarding the disclosure of director compensation?

Director compensation will be reported in tabular format, accompanied by narrative disclosure of additional material information. The Director Compensation Table resembles the SCT but presents information only with respect to the company's last completed fiscal year. The columns of the table include: Fees Earned or Paid in Cash; Stock Awards; Option Awards; Non-Equity Incentive Plan Compensation; Change in Pension Value and Nonqualified Deferred Compensation Earnings; All Other Compensation; and Total Compensation.

The All Other Compensation column of the Director Compensation Table would include, but not be limited to:

- all perquisites and other personal benefits if the total is $10,000 or greater;
- all earnings on compensation that is deferred on a basis that is not tax-qualified;
- all tax reimbursements;
- annual company contributions or other allocations to vested and unvested defined contribution plans;
- for any security of the company or its subsidiaries purchased from the company or its subsidiaries (through deferral of fees or otherwise) at a discount from the market price of such security at the date of purchase, unless the discount is generally available to all security holders or to all salaried employees of the company, the compensation cost computed in accordance with FAS 123-R;
- aggregate annual increase in actuarial value of all defined benefit and actuarial pension plans;
- annual company contributions to vested and unvested defined contribution and other deferred compensation plans;
- all consulting fees;
- awards under director legacy or charitable awards programs;
- the dollar value of any dividends or other earnings paid in stock or option awards when the dividend or earnings were not factored into the grant date fair value; and
- the dollar value of any insurance premiums paid by, or on behalf of, the company for life insurance for the director's benefit.

Directors may be grouped in a single row of the table if all of their elements and amounts of compensation are identical. In addition to the disclosure specified in the columns of the table, companies would be required to disclose, for each director, by footnote to the appropriate column, the aggregate numbers of stock awards and option awards outstanding at fiscal year end. Following the table, narrative disclosure would describe any material factors necessary to an understanding of the table. Such factors may include, for example, a breakdown of types of fees. Disclosure regarding option timing or dating practices may be necessary under this narrative disclosure requirement when the recipients of the stock option grants are directors of the company.

Disclosure of Related Party Transactions

What changes has the SEC made to related person transaction disclosure?

The SEC has significantly modified the disclosure currently required by Item 404 of Regulation S-K. These revisions are intended to streamline and modernize related person transaction disclosure through the use of a more principles-based approach. The revisions have four parts:

- revised Item 404(a) contains a general disclosure requirement for related person transactions, eliminating the distinction between indebtedness and other types of related party transactions;
- revised Item 404(b) requires disclosure on a company's policies and procedures for the review, approval or ratification of related person transactions;
- revised Item 404(c) requires disclosure regarding a company's promoters and certain control persons; and
- new Item 407 consolidates corporate governance disclosure requirements.

Which transactions with related persons must be disclosed?

The new rules eliminate many of the bright-line disclosure thresholds formerly contained in the instructions to Item 404(a) in favor of a broad materiality analysis. More specifically, revised Item 404(a) provides that a company must disclose any transaction since the beginning of the company's last fiscal year, or any currently proposed transaction, in which the company was or is to be a participant and

in which any related person had, or will have, a direct or indirect material interest, if the amount involved exceeds $120,000. The $120,000 minimum is an increase over the former $60,000 threshold. In addition, the SEC retained the materiality standard for disclosure. Materiality of any interest continues to be determined on the basis of the significance of the information to investors in light of all the circumstances. Of particular importance to this determination is the relationship of the related persons to the transaction and with each other, the importance of the interest to the person having the interest and the amount involved in the transaction. As before, not all transactions in excess of $120,000 automatically cross the materiality threshold.

Why is the SEC using "participant" to a transaction rather than "party"?

Revised Item 404 requires disclosure of a transaction only if the company is a "participant." This differs from the former requirement that the company be a "party" to a transaction. The SEC made this change so that Item 404 would encompass situations in which a company benefits from a transaction but is not technically a contractual "party" to the transaction.

Does revised Item 404(a) now cover indebtedness transactions?

Modified Item 404(a) encompasses transactions involving indebtedness, which was formerly covered separately under Item 404(c). Decisions regarding disclosure of indebtedness transactions are made through the same analysis as other related person transactions. Item 404(a) also requires disclosure of all material *indirect* interests in indebtedness transactions of related persons. For example, disclosure is now required if an executive officer has a material indirect interest in an indebtedness transaction exceeding $120,000 between the company and another entity due to the executive officer's ownership interest in the other entity. The SEC did not, however, adopt the proposed requirement that companies disclose indebtedness transactions with significant shareholders and their immediate family members.

How broad is the term "transaction" under the revised rules?

The term "transaction" is broadly defined to include, but is not limited to, any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships. The definition includes indebtedness and guarantees of indebtedness.

Who is a "related person" under the revised rules?

The term "related person" means any person who was in any of the following categories at any time during the specified period for which disclosure under Item 404(a) is required: (1) any director or executive officer of the company and his or her immediate family members, and (2) if disclosure is provided in a proxy or information statement relating to the election of directors, any nominee for director and the immediate family members of any nominee for director. In addition, a "related person" also includes a security holder known to the company to beneficially own more than five percent of any class of the company's voting securities or any immediate family member of such person, when a transaction in which such security holder or family member had a direct or indirect material interest occurred or existed.

Disclosure is required for a person who was a "related person" at any time during the last fiscal year even if they were not a "related person" at the time of the applicable transaction with the company or if the person was no longer a related person at the end of the year. Transactions with persons who have been or who become significant shareholders (or their immediate family members), but are not at the time of the transaction, may be excluded. Disclosure is required, however, if the transaction begins before a significant shareholder becomes a significant shareholder and continues (for example, through the ongoing receipt of payments) after the person becomes a significant shareholder.

The term "immediate family member" of a related person includes any 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 any director, nominee for director, executive officer, or significant shareholder of the company. This differs from the former definition in that it adds stepchildren, stepparents, and any person (other than a tenant or employee) sharing the household of any director, nominee for director, executive officer, or significant shareholder of the company.

How has the SEC defined the "amount involved" for purposes of Item 404?

The definition of "amount involved" incorporates two concepts previously in Item 404 regarding calculation of the "amount involved" and clarifies that the amounts must be reported in dollars, even if the amount was set or expensed in a different currency. "Amount involved" means the dollar value of the transaction, or series of similar transactions, and includes: (1) in the case of any lease or other transaction providing for periodic payments or installments, the aggregate amount of all periodic payments or installments due on or after the beginning of the company's last fiscal year, including any required or optional payments due during or at the conclusion of the lease or other transaction providing for periodic payments or installments; and (2) in the case of indebtedness, the largest aggregate amount of all indebtedness outstanding at any time since the beginning of the company's last fiscal year and all amounts of interest payable on it during the last fiscal year.

What disclosures are required for related persons transactions?

The revised rules require a company to describe the transaction, including:

- the person's name and relationship to the company;
- the person's interest in the transaction with the company, including the related person's position or relationship with, or ownership in, a firm, corporation or other entity that is a party to or has an interest in the transaction; and
- the approximate dollar value of the amount involved in the transaction and of the related person's interest in the transaction.

A company is also still required to disclose any other information regarding the transaction or related person that is material to investors in light of the circumstances of the particular transaction. A company is no longer required to disclose amounts possibly owed to the company under Section 16(b) of the Exchange Act.

Are there exceptions to the disclosure requirements?

The revised rules provide for categories of exceptions from disclosure under Item 404(a). The first category of transactions involves compensation. Disclosure of compensation to an executive officer is not required under Item 404(a) if:

- the compensation is reported under Item 402 of Regulation S-K, or
- the executive officer is not an immediate family member of a related person, such compensation would have been reported under Item 402 as compensation earned for services to the company if the executive officer was an NEO, and such compensation was approved, or recommended to the company's board of directors for approval, by the company's compensation committee or group of independent directors performing a similar function.

This may cause many companies to have their compensation committees as a matter of course approve all executive officers' compensation in order to avoid such Item 404 disclosure obligations. The revised rules also provide that Item 404(a) does not require disclosure of compensation to a director if the compensation is reported under Item 402(k).

The second category of exceptions involves three types of situations, the first two of which involve indebtedness transactions. First, the following items of indebtedness are excluded from the indebtedness calculation and need not be disclosed: amounts due from related persons for purchases of goods and services subject to usual trade terms, for ordinary business travel and expense payments, and for other transactions in the ordinary course of business. Second, if the lender is a bank, savings and loan association, or broker-dealer extending credit under Federal Reserve Regulation T and the loans are not disclosed as nonaccrual, past due, restructured or potential problems, disclosure under new Item 404(a) may consist of a statement, if correct, that the loans to such persons satisfied the following conditions:

- were made in the ordinary course of business;
- on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable loans with persons not related to the lender; and
- did not involve more than the normal risk of collectibility or present other unfavorable features.

Another exception provides that a person who has a position or relationship with a firm, corporation or other entity that engages in a transaction with the

company is not deemed to have an indirect material interest under Item 404(a) if:

- the interest arises only: (i) from the person's position as a director of another corporation or organization that is a party to the transaction; or (ii) from the direct or indirect ownership by such person and all other related persons, in the aggregate, of less than a ten percent equity interest in another person (other than a partnership) which is a party to the transaction; or (iii) from both such position and ownership; or
- the interest arises only from the person's position as a limited partner in a partnership in which the person and all other related persons have an interest of less than ten percent, and the person is not a general partner of and does not have another position in the partnership.

Finally, disclosure under Item 404(a) is not required under three other types of circumstances. First, disclosure is not required as to any transaction where the rates or charges involved in the transaction are determined by competitive bids, or the transaction involves the rendering of services as a common or contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority. Second, disclosure need not be provided if the transaction involves services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture, or similar services. Third, disclosure need not be provided pursuant to Item 404(a) if the interest of the related person arises solely from the ownership of a class of equity securities of the company and all holders of that class of equity securities of the company received the same benefit on a pro rata basis. This final exception would obviate the need to disclose a related person receiving over $120,000 in dividends on company stock in a year where those dividends are paid on the same terms as for all other stockholders.

What must companies disclose about their policies and procedures for approval of related person transactions?

The SEC has adopted a new requirement that companies must describe the material features of the company's policies and procedures for the review, approval or ratification of transactions with related persons that are reportable under Item 404(a). The description must include the material features of the policies and procedures necessary for an understanding of them. Examples of the features that may be described, depending on the circumstances, include the following:

- the types of transactions that are covered by such policies and procedures and the standards to be applied pursuant to the policies and procedures;
- the persons or groups of persons on the board of directors or otherwise who are responsible for applying the policies and procedures; and
- whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.

In addition, Item 404(b) requires that companies specifically disclose any transactions required to be reported under Item 404(a) where the company's policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed. Item 404(b) does not, however, require disclosure for any transaction that occurred at a time before the related person had the relationship that would trigger disclosure under Item 404(a) if the transaction did not continue after the related party had that relationship.

What must companies disclose about transactions with promoters and control persons?

Companies must now disclose the identity of promoters and their transactions with those promoters if the company had a promoter at any time during the last five fiscal years. The disclosure must include:

- the names of the promoters;
- the nature and amount of anything of value received by each promoter from the company and the nature of any amount of consideration received by the company; and
- additional information regarding any assets acquired by the company from a promoter.

The above disclosure is required in Securities Act registration statements on Form S-1 or Form SB-2 and on Exchange Act Form 10 or Form 10-SB. This disclosure requirement is a departure from the former rules which required such disclosure only if a company had been organized within the last five years. The new rules also require the same disclosure that is required for promoters for any person who acquired control, or is part of a group that acquired control, of an issuer that is a shell company.

How has the SEC changed corporate governance disclosure?

The SEC has consolidated under new Item 407 of Regulation S-K the disclosure requirements regarding director independence and related corporate governance. New Item 407 consolidates corporate governance disclosure requirements previously located in several places under the former rules and the company's principal markets' listing standards.

What must companies disclose regarding director independence?

If a company is an issuer with securities listed, or for which it has applied for listing, on a national securities exchange or an automated inter-dealer quotation system of a national securities association which requires that a majority of the board of directors be independent, Item 407(a) requires that the company disclose the directors and director nominees it identifies as independent (and committee members not identified as independent) using a definition of independence that it uses for determining compliance with the applicable listing standards. Similarly, if the company is not a listed issuer, the company must disclose the directors and director nominees it identifies as independent (and committee members not identified as independent) using a definition for independence for directors (and for committee members) of a national securities exchange or national securities association specified by the company. A non-listed issuer must apply the selected independence definition consistently to all directors and must use the independence standards of the same national securities exchange or national securities association to determine the independence of members of the compensation, nominating and audit committees.

If the company is a listed issuer whose securities are listed on a national securities exchange or in an inter-dealer quotation system which has requirements that a majority of the board of directors be independent, and also has exemptions to those requirements (for board or committee member independence) upon which the company relied, the company must disclose the exemption relied upon and explain the basis for its conclusion that such exemption is applicable. Similar disclosure is required for those companies that are not listed issuers but would qualify for an exemption under the listing standards selected. In addition, small business issuers listed on exchanges where at least half of the members of the board of directors, rather than a majority, are required to be independent must comply with the disclosure requirements specified in Item 407(a).

Under new Item 407, a company must also disclose whether the adopted definitions of independence are posted on the company's web site, or include the definitions as an appendix to the company's proxy materials at least once every three years. If a company materially amends its independence definition, the new definition must be included as an appendix to the company's next proxy materials. If a company's independence definitions are not on the company's web site, or included as an appendix to that year's proxy statement, the company must disclose in which of the previous fiscal years the definitions were last included in the proxy materials. In addition, if the audit committee charter is posted on the company's web site, it no longer needs to be delivered to security holders.

Item 407 also requires, for each director or nominee identified as independent, a description of any transactions, relationships or arrangements not disclosed under Item 404(a) that were considered by the board of directors in determining whether the applicable independence standards were met. This disclosure must be made on a director by director basis, with separate disclosure of categories or types of transactions, relationships or arrangements for each director and director nominee. The description must be sufficiently detailed so that the nature of the transactions, relationships or arrangements is readily apparent.

The Item 407 independence disclosures must be provided for any person who served as a director of the company during any part of the year for which disclosure must be provided, even if the person no longer serves as a director at the time of filing the registration statement or report or, if the information is in a proxy statement, if the director's term of office as a director will not continue after the meeting.

What new disclosures are required regarding compensation committees?

In addition to the disclosures currently required regarding audit and nominating committees, Item 407 requires similar new disclosures regarding compensation committees. For instance, a company must state whether the compensation committee has a charter, and if it does make the charter available

through its web site or proxy materials in one of the ways that audit and nominating committee charters may be made available. Item 407 also requires that a company describe its processes and procedures for the consideration and determination of executive and director compensation, including:

- the scope of authority of the compensation committee (or persons performing the equivalent functions);
- the extent to which the compensation committee (or persons performing the equivalent functions) may delegate any authority to other persons, specifying what authority may be so delegated and to whom;
- any role of executive officers in determining or recommending the amount or form of executive and director compensation; and
- any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether such consultants are engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.

In addition, the disclosure formerly required under Item 402 regarding compensation committee interlocks and insider participation in compensation decisions is now consolidated in Item 407.

Has the SEC eliminated proxy disclosure of directors resigning or not standing for re-election?

For registrants other than registered investment companies, the previous proxy disclosure requirement regarding directors that have resigned or declined to stand for re-election has been eliminated because it is no longer necessary as it is required to be disclosed on Form 8-K. For registered investment companies which do not file Form 8-K, the disclosure requirement has been moved to Item 22(b) of Schedule 14A.

What are the "plain English" requirements of the new rules?

Companies must prepare their executive and director compensation, related person transactions, beneficial ownership and corporate governance disclosures included in Exchange Act reports using plain English principles. The plain English guidance consists of a series of "dos" and "don'ts" as follows:

- ***Plain English Dos***
  Present information in clear, concise sections, paragraphs and sentences, using short sentences, definite, concrete, everyday words, the active voice, descriptive headings and subheadings and a tabular presentation or bullet lists for complex material, and in designing the presentation of the information, include pictures, logos, charts, graphs, schedules, tables or other design elements so long as the design is not misleading and the required information is clear, understandable, consistent with applicable disclosure requirements and any other included information, drawn to scale and not misleading.
- ***Plain English Don'ts***
  Avoid the following: legal jargon and highly technical business and other terminology; frequent reliance on glossaries or defined terms as the primary means of explaining information, defining terms in the glossary or other section of the document only if the meaning is unclear from the context and using a glossary only if it facilitates understanding of the disclosure; legalistic or overly complex presentations that make the substance of the disclosure difficult to understand; vague "boilerplate" explanations that are imprecise and readily subject to different interpretations; complex information copied directly from legal documents without any clear and concise explanation of the provision(s); and disclosure repeated in different sections of the document that increases the size of the document but does not enhance the quality of the information.

What steps should company management be taking to ensure the company's compliance with the new rules, and what steps should the compensation committee take to ensure it is fulfilling its role in the disclosure of executive and director pay?

During the open meeting at which the new rules were adopted, the SEC staff observed that the prior disclosure rules adopted in 1992 had remained stagnant despite dramatic changes in pay practices and that company disclosures had drifted toward boilerplate and legalese that was not helpful to most

investors. The staff assured the Commissioners that it would not tolerate such shortcomings in the future. The SEC staff can be expected to more closely monitor executive compensation disclosures, particularly in the initial year or two for which the new rules will be in effect, and in appropriate instances to require the rewriting of sections, particularly the CD&A, that do not meet the letter or spirit of the new rules.

The issuance of the new rules presents a good opportunity for companies to review the respective roles of management and the compensation committee in determining the design and disclosure of executive and director pay. A starting point for this analysis is the CD&A. The CD&A is a "company document" that must include a discussion and analysis of the material factors underlying compensation policies and decisions reflected in the data presented in the tables. This is not intended to be a theoretical discussion – it should reflect the actual policies and decisions of the company through its compensation committee. Accordingly, the committee must engage in a process, during its meetings and discussions on key compensation decisions, that supports the explanation ultimately contained in the CD&A. It is not advisable to begin fashioning a rationale for prior decisions only as the CD&A is being prepared after the close of the fiscal year.

Suggested action steps for the company and the compensation committee include:

- Educate management and the board regarding the requirements of the new rules. The principal executive officer, the principal financial officer, the company's General Counsel and the members of the compensation committee in particular must become familiar not only with the general thrust of the new requirements but with the details to an extent sufficient to effectively discharge their compliance responsibilities. Outside counsel and consultants may be helpful to this education effort.
- Define the respective roles of management, the compensation committee and the full board in ensuring the company's compliance with the executive compensation requirements. To the extent necessary, adjust the charter of the compensation committee to reflect the new disclosure landscape.
- Determine which company departments and personnel are needed to compile the compensation data for the tables and narrative disclosures and those who will be responsible for ensuring that the data is properly reported in the tables and narrative.
- Identify and retain special outside expertise (*e.g.*, legal, accounting and actuarial) whose assistance will be required.
- Identify, at least preliminarily, the executives who will have to be included in the tables and prepare mock-ups of the CD&A, the tables and the narrative disclosure based upon the most recent information available. It may be helpful in this regard to review the 2006 proxy filings of companies that have attempted to comply with some or all elements of the proposed rules.
- Focus in particular on items that will be more visible under the new rules, such as perquisites and termination and change in control payment arrangements, and consider whether any changes to such arrangements are appropriate in anticipation of increased public scrutiny of them.
- Review existing stock option grant procedures and adjust them, as appropriate, to conform with "best practices."
- This effort to prepare the mock-ups will help to identify the processes and procedures that will be necessary to assemble the information for the tables and other disclosure. To the extent possible, these processes and procedures should be codified in written compliance guidelines.

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