

SEC Finalizes Executive Compensation Disclosure Rules

July 28, 2006

On July 26, the SEC adopted revised executive compensation disclosure rules. For the text of the SEC press release announcing this action, see <http://www.sec.gov/news/press/2006/2006-123.htm>.

The final SEC rules follow the proposed rules in large part (for a summary, see http://www.morganlewis.com/pubs/EB_SECCompensationDisclosure_LF_18jan06.pdf), but incorporate a number of important revisions and additions that are highlighted below. Please note that the final text of the rules has not yet been released; as a result, this LawFlash is based on the July 26 press release and comments made during the SEC's open meeting at which the rules were adopted.

Executive Summary

The SEC's new executive compensation disclosure requirements must be followed in proxies filed during the 2007 proxy season (i.e., proxy statements including executive compensation information for fiscal years ending on or after December 15, 2006). The rules will require increased disclosure regarding many elements of compensation, which must be reflected in a series of tables and accompanying narrative. The new rules modify the original SEC proposal in a number of key areas, including: (1) the inclusion of a compensation committee report in addition to the Compensation Discussion and Analysis ("CD&A"), (2) several revisions to the tabular disclosure and (3) disclosure regarding registrant's policies and practices in the area of options grants, including with respect to determination of exercise price and the timing of grants.

Compensation Discussion & Analysis/Compensation Committee Report

A key element of the new rules will be the CD&A, which is designed to provide clear, principles-based narrative disclosure regarding company policies and decisions relating to executive compensation. Initially, the SEC proposed that the CD&A replace the compensation committee report. However, the final rules will retain the compensation committee report, albeit in a very abbreviated fashion, similar in character to the audit committee report included in annual meeting proxy statements. The compensation committee report must include disclosure as to whether the compensation committee has reviewed and discussed the CD&A with management and whether, based on the review and discussion, the committee has recommended to the board of directors that the CD&A be included in the company's proxy statement.

Like the proposed rules, the final rules provide that the CD&A will be filed, not furnished, so that the disclosure will be covered by the CEO and CFO certifications in periodic reports and be subject to certain Securities Act and Securities Exchange Act liabilities. On the other hand, the compensation committee report will be furnished, not filed.

Tabular and Narrative Disclosure

The rules will follow a tabular approach, supplemented by extensive narrative disclosure to address the components of each named executive's compensation. The principal table will be the Summary Compensation Table, which is designed to enable investors to ascertain "total" compensation of each executive (expressed as a dollar figure). The final rule will include several revisions to the tabular disclosures as initially proposed, including the following:

- In determining the most highly paid executive officers, companies will exclude increases in actuarial present value of accumulated pension benefits and earnings on nonqualified deferred compensation.
- Companies need to include only above-market or preferential earnings in disclosing nonqualified defined compensation earnings in the Summary Compensation Table (although the full amount will be reflected in another table).
- A new column in the Summary Compensation Table will include increases in actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation. This change is designed to facilitate determination of the most highly compensated executive officers.
- It appears that the two proposed tables dealing with current performance-based and non-performance-based awards, which were to supplement the Summary Compensation Table, will be replaced by a single table addressing plan-based awards. This table will include disclosure of the grant date, the closing market price on the grant date if greater than the exercise price of the award, and the date on which the compensation committee took action to grant the awards if that date is different from the grant date.
- The table addressing outstanding equity awards at fiscal year-end will require information on an individual grant (rather than aggregate) basis.
- The pension benefits table (proposed as the retirement plan potential annual payments and benefits table) will require disclosure of the actuarial present value of each named executive officer's accumulated pension benefit, rather than estimated annual benefits.

In addition, the adopting release will include additional guidance on perquisite disclosure.

Option Disclosure

In light of the current controversy relating to pricing of certain options as of a date prior to the actual grant date (so-called "option backdating") and timing of option grants to precede the release of material

nonpublic information (so-called “spring loading”), the final rules include expanded disclosure requirements regarding the issuance, pricing and timing of stock options.

Under the final rules, the CD&A must discuss the company’s option granting practices, including, as appropriate, the Company’s reasons for using particular grant dates and the methods used to select terms of awards (such as exercise prices).

With regard to the timing of stock option grants, the rules will require disclosure of whether the company has a policy regarding the coordination of option issuances with the release of material nonpublic information. The disclosure must also address how any such policy as it relates to executive grants compares to the company’s practice with employees generally. Further, the disclosure must address the role of the compensation committee and executive officers in the timing of option grants, as well as addressing the company’s policy regarding the coordination of new hire grants with the release of material, nonpublic information. Similar types of disclosures will be required if a company awards options with an exercise price that differs from the underlying stock price on the date of the grant.

These disclosure requirements are an addition to the proposed disclosures, and may pose a particular challenge for management and compensation committees.

Retention of Stock Performance Graph in the “Glossy” Annual Report

The SEC initially proposed the abandonment of the stock performance graph (comparing the company’s stock performance to a broad equity-based index and a published industry index or a peer group). The final rules retain the stock performance graph, although the graph will be set forth in the “glossy” annual report, not in the CD&A or compensation committee report.

“Katie Couric” Rule Modified

The proposed rules would have required disclosure of compensation information on up to three additional employees who are not executive officers but who receive compensation greater than that of any of the named executive officers. (This proposed rule became known as the “Katie Couric rule” since it would likely have resulted in disclosure of compensation packages of highly paid television and movie stars, athletes and other celebrities employed by public companies). The proposal was widely criticized as leading to unnecessary disclosure of confidential information. The SEC has determined to repropose the rule so that the disclosure requirements will not apply to employees who have “no responsibility for significant policy decisions” at the company, a subsidiary or a principal business unit, division or function. In addition, the provision would apply only to large accelerated filers.

Other Provisions

The final rules apparently will include requirements, largely as proposed, regarding disclosure of director compensation, related party transactions, director independence and compensation committee processes and procedures for consideration of executive compensation. In addition, information regarding stock pledges by management will be required. The final rules also modify the Form 8-K filing requirements regarding employment arrangements to focus more narrowly on material compensation arrangements and modifications for named executive officers. Lastly, the final rules require that the disclosure generally be provided in plain English.

Conclusion

The new SEC disclosure requirements are now a reality and must be dealt with for the 2007 proxy season. We recommend that, promptly after the text of the final rules is released, public companies begin working to comply with the final rules, especially the CD&A and data requirements. We emphasize that this process will certainly be time-consuming, and will require the attention of senior management, the compensation committee and the company's board.

For more information, please contact your Morgan Lewis attorney or one of the contacts listed at the end of this LawFlash:

Los Angeles

John F. Hartigan 213.612.2630 jhartigan@morganlewis.com

New York

Stephen P. Farrell 212.309.6050 sfarrell@morganlewis.com
Howard A. Kenny 212.309.6843 hkenny@morganlewis.com
Gary S. Rothstein 212.309.6360 grothstein@morganlewis.com

Palo Alto

S. James DiBernardo 650.843.7560 jdibernardo@morganlewis.com
Zaitun Poonja 650.843.7540 zpoonja@morganlewis.com

Philadelphia

Justin W. Chairman 215.963.5061 jchairman@morganlewis.com
Robert J. Lichtenstein 215.963.5726 rlichtenstein@morganlewis.com
Alan Singer 215.963.5224 asinger@morganlewis.com
Mims Maynard Zabriskie 215.963.5036 mzabriskie@morganlewis.com

Washington, D.C.

Althea R. Day 202.739.5366 aday@morganlewis.com
Linda L. Griggs 202.739.5245 lgriggs@morganlewis.com
David A. Sirignano 202.739.5420 dsirignano@morganlewis.com
George G. Yearsich 202.739.5255 gyearsich@morganlewis.com

About Morgan, Lewis & Bockius LLP

Morgan Lewis is a global law firm with more than 1,250 lawyers in 20 offices located in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend in emails, please see <http://www.morganlewis.com/circular230>.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as imparting legal advice on any specific matter.

© 2006 Morgan, Lewis & Bockius LLP. All Rights Reserved.