The SEC's Proposed Executive Compensation and Related-Party Disclosure Reforms

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Table of Contents

Introduction . . . 3

Purpose and objectives . . . 3

Overview of proposals . . . 3

Executive and Director Compensation Disclosure . . . 6

Compensation discussion and analysis (CD&A) . . . 6

Compensation tables . . . 8

Guidance on perquisites . . . 11

Exercises of previously-awarded equity . . . 14

Post-employment compensation . . . 15

Other potential post-employment payments . . . 17

Officers covered by executive compensation rules . . . 18

Interplay of Items 402 and 404 . . . 19

Other proposed changes . . . 19

Compensation of directors . . . 20

Small business issuers . . . 21

Foreign private issuers . . . 21

Business development companies . . . 21

Form 8-K Changes . . . 23

Related-Party Transaction Disclosure . . . 25

Broad principle for disclosure. . . . 25

Disclosure requirements . . . 27

Exceptions . . . 28

Procedures for approving related-party transactions . . . 29

Promoters . . . 29

Small business issuers . . . 30

Foreign private issuers . . . 30

Investment companies . . . 30

Corporate governance . . . 31

Beneficial Ownership Disclosure . . . 33

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Introduction

The Securities and Exchange Commission has proposed a sweeping overhaul of its rules governing disclosure of executive and director compensation, related person transactions, director independence and other corporate governance matters. See Release No. 33-8655 (SEC 2006), FED. SEC. L. REP. ¶87,517. The proposed revisions to the executive and director compensation disclosure rules are intended to provide investors with a clearer and more complete picture of compensation paid to principal executive officers, principal financial officers, the highest paid executive officers and directors. The deadline for submitting comments on the proposal is April 10, 2006.

Purpose and objectives

The broad purpose of the new regime is to improve disclosure by including all elements of executive and director compensation. It is about wage clarity, not wage controls. Indeed, Chairman Christopher Cox noted that the SEC lacks statutory authority to impose salary caps on corporate executives and would be out of bounds to attempt the same through indirection. But by improving the total mix of information available to the marketplace, he emphasized, the Commission can help shareholders and board compensation committees assess the information themselves and reach their own conclusions.

Similarly, in the proposing release, the SEC emphasized that it does not seek to foster any given direction. Rather, the agency's objective is to increase transparency to enable decision makers to make more informed decisions, which could result in different policies or increase investor confidence in existing policies.

At the end of the day, it is the board's job, not the SEC's, to determine how best to align executive compensation with corporate performance in order to determine the appropriate level of executive pay, and to decide on the metrics for determining it. For its part, the SEC will ensure that investors have available all of the compensation information they need, presented in a clear and understandable format that they can use. Thus, while it is up to the board to decide how much to pay the CEO, Chairman Cox noted, companies will have to disclose a clear explanation of how they arrived at both the amount and the measurement.

Overview of proposals

Under this broad policy, the goal of the executive and director compensation proposals is to provide investors with clearer, better organized and more complete disclosure regarding the mix, size and incentive components of executive and director compensation. The proposals would accomplish this goal by eliminating some tables and other disclosures that may no longer be useful to investors, revising other tables so that they are more informative, and requiring new tabular and new quantitative estimate disclosure for retirement plans and similar benefits and director compensation.

The proposals would also require enhanced narrative disclosure, in the form of a Compensation Discussion and Analysis section, and narrative disclosure accompanying the tables, to explain the significant factors underlying the compensation decisions

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reflected in the tabular data. The proposals would require companies to report the total amount of compensation for named executive officers and directors, and provide important context to the disclosure of total compensation. According to Chairman Cox, the new CD&A will provide both an obligation and an opportunity for a company to explain its compensation policies.

Improved disclosure under the proposals of certain forms of compensation, such as stock, option, and incentive plan-based compensation, as well as retirement and other post-employment compensation, combined with the ability of investors to track the elements of executive compensation and the relative weights of those elements over time, as well as the reasons why companies allocate compensation in the manner that they do, will enable investors to make comparisons both within and across companies. A presentation facilitating the comparability and different elements of compensation in different companies should make it easier for investors to analyze both the manner of compensation across companies and the quality of disclosure of compensation across companies. Disclosure of total compensation would benefit investors by reducing the need to make individual computations in order to assess the size of current compensation.

Further, improved compensation disclosure will enhance investors' understanding of this use of corporate resources and the actions of boards of directors and compensation committees in making decisions in this area. Particularly with respect to the proxy statement for the annual meeting at which directors are elected, this improved disclosure would provide better information to shareholders for purposes of evaluating the actions of the board of directors in fulfilling its responsibilities to the company and its shareholders.

The SEC believes that the extent to which increased transparency and completeness in executive and director compensation disclosure would result in broader benefits partially depends on the extent to which current compensation practices are aligned with the interests of investors as reflected in their investment and voting decisions. Any changes to a company that might occur, including changes in corporate governance, changes in control, or changes in the employment of particular executives could depend to some extent on the degree to which improved transparency in executive and director compensation would affect investor decisionmaking with respect to that company.

Improved transparency in executive and director compensation under these proposals could have other benefits in terms of the efficiency of affected corporations with regard to the use of resources for executive compensation relative to other corporate needs, as well as improvements in efficiency of managerial labor markets. Benefits such as these depend on the extent to which the proposals, including requirements to disclose a total amount of compensation and more detail regarding compensation policies, could alter existing policies in these areas.

Proposed amendments to Form 8-K would facilitate shareholder and investor access to real time disclosure of public companies' significant personnel and compensation decisions by focusing this disclosure only on what are the most important compensatory arrangements with executive officers and directors. This information would be filed pursuant to Item 5.02(e) of Form 8-K. To find this information, shareholders and investors will no longer have to examine multiple Item 1.01 disclosures relating to other actions. Companies would also be relieved of obligations to quickly report arguably less

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important compensation information on Form 8-K. With real time disclosure focused on compensation arrangements with executives and directors that are unquestionably or presumptively material, the obligation to file Form 8-K with respect to other compensatory arrangements would be eliminated.

The proposed amendments to Item 404 of Regulation S-K would provide investors with more complete disclosure of related person transactions and director independence, and new disclosure regarding a company's policies and procedures for the review, approval or ratification of relationships with related persons. These proposals would enhance investor understanding of how corporate resources are used in related person transactions, and provide improved information to shareholders for purposes of better evaluating the actions of the board of directors and executive officers in fulfilling their duties to the company and its shareholders.

Other changes will significantly revise the rules requiring disclosure on the extent to which executive officers, directors, significant shareholders and other related persons participate in financial transactions and relationships with the company. In addition, the beneficial ownership disclosure rules would be amended to require disclosure regarding pledges of securities by management and directors' qualifying shares.

The SEC proposes that most of the disclosure that would be required under the proposed amendments be provided in plain English. Plain English would be required both in the rewriting of existing disclosures, as well as in the drafting of new disclosures, such as the Compensation Discussion and Analysis.

The proposed changes to Item 402 of Regulation S-K, the primary vehicle for executive compensation disclosure, would apply a broad approach that would eliminate some tables, simplify or refocus other tables, reflect total current compensation in the summary compensation table, and reorganize the table to group together compensation elements that have similar functions so that the quantitative disclosure is both more informative and more easily understood. This improved quantitative disclosure would be complemented by enhanced narrative disclosure comprehensively describing the context in which compensation is paid and received. In particular, the narrative disclosure requirements would provide transparency regarding company compensation policies and procedures, and be sufficiently flexible to operate effectively as new forms of compensation continue to evolve.

Current Item 404 of Regulation S-K dealing with related-party transactions was adopted to consolidate various provisions previously adopted in a piecemeal fashion. The proposals would streamline and modernize Item 404 while making it more principles-based. Indebtedness of related persons is limited by the Sarbanes-Oxley Act, and the disclosure requirement regarding indebtedness of related persons would be combined into the requirement regarding other transactions with related persons. This consolidated disclosure requirement would apply to an expanded group of related persons. While the current principles for disclosure would be retained, the proposal would increase the $60,000 threshold for disclosure to $120,000 and eliminate or reduce the scope of certain instructions delineating what transactions are reportable or excludable.

Existing disclosure requirements in Item 404 regarding transactions with promoters would be slightly expanded to apply when a company had a promoter over the past five

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years, as well as to require analogous disclosure regarding transactions with control persons of a shell company.

With respect to registered investment companies and business development companies, proposed amendments to Schedule 14A and to Forms N-1A, N-2 and N-3 would similarly increase to $120,000 the current $60,000 threshold for disclosure of certain interests, transactions, and relationships of each director who is not an interested person of the fund within the meaning of Section 2(a)(19) of the Investment Company Act, and their immediate family members. In addition, Form N-2 would require business development companies to include the compensation disclosure required by Item 402.

With regard to corporate governance, the SEC proposes new Item 407 of Regulation S-K that would consolidate disclosures required in several places throughout the rules addressing director independence, board committee functions and other related governance matters. This proposed Item, which would require new disclosure regarding director independence and board committees, is intended to enhance disclosures regarding independence required by corporate governance listing standards of national securities exchanges and associations. Also proposed are conforming revisions to Schedule 14A relating to the independence of members of nominating and audit committees of investment companies.

To the extent that shares beneficially owned by named executive officers and directors are used as collateral for loans, they are subject to risks or contingencies that do not apply to other shares beneficially owned by these persons. These circumstances have the potential to influence management's performance. As a result, the SEC believes that the existence of these securities pledges could be material to shareholders and should be disclosed. Thus, Item 403 of Regulation S-K would require this disclosure as well as disclosure regarding directors' beneficial ownership of qualifying shares.

Executive and Director Compensation Disclosure

The proposed revisions to the compensation disclosure rules are intended to provide investors with a clearer and more complete picture of compensation to principal executive and financial officers, the other highest paid executive officers, and directors. The proposal combines a broader-based tabular presentation with improved narrative disclosure supplementing the tables.

Compensation discussion and analysis (CD&A)

The compensation disclosure would begin with a narrative providing a general overview. See Release No. 33-8655, Part II.A. Similar to the currently required Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), the SEC proposes a Compensation Discussion and Analysis that would discuss and analysis the material factors underlying compensation policies and decisions reflected in the data presented in the tables. This overview would address in one place these factors with respect to both the separate elements of executive compensation and executive compensation as a whole.

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The Compensation Discussion and Analysis, unlike the current Compensation Committee Report and the Performance Graph, but like all of the rest of the current compensation disclosure, would be considered filed and as such would be part of the documents for which certifications apply.

Following the CD&A, disclosure of executive compensation would fall into three broad categories: 1) compensation; 2) equity compensation; 3) retirement and other post-employment benefits. The SEC proposes improved tabular disclosure for each of these three categories, supplemented by narrative providing information necessary to an understanding of the information presented in the tables. This narrative disclosure, together with the CD&A, would replace the currently required Compensation Committee report and the Performance Graph.

The CD&A should put into context the compensation disclosure provided elsewhere. It is envisioned as a narrative principles-based overview explaining material elements of the company's compensation for named executive officers. It will focus on the objectives of the company's compensation programs and what such programs are designed to reward and not reward. It will describe each element of compensation and why the company has decided to pay each element, as well as how the amount for each element is determined. More broadly, the narrative will discuss how each element and the company's decisions regarding that element fits into the company's overall compensation objectives and affects decisions regarding other elements. Forward looking information in the CD&A would fall within the safe harbor for disclosure of such information. See Securities Act Section 27A and Exchange Act Section 21E.

The SEC cautions that the CD&A should not resort to boilerplate disclosure. It is intended to put into perspective for investors the numbers and narrative that follow it. Because it is principles-based, the CD&A should identify the disclosure concept and provide several illustrative examples tailored to the company. At the same time, the scope of the CD&A is intended to be comprehensive, so that it would call for discussion of post-termination as well as in-service compensation arrangements.

The CD&A should be sufficiently precise to identify material differences in compensation policies and decisions for individual named executive officers. When policies or decisions are materially similar, officers could be grouped together. But when the policies are materially different, compensation would be discussed separately.

In proposed instructions, the SEC clarifies that the CD&A should focus on the principles underlying the company's executive compensation policies and decisions, and the most important factors relevant to analysis of those policies and decisions, without repeating the more detailed information set forth in the tables and the related narrative disclosures that follow them. It is similarly clarified that companies need not disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any factors or criteria involving confidential business information, the disclosure of which would have an adverse effect on the company.

In applying this instruction, the standard for companies to use when determining whether disclosure would have an adverse effect on the company should be the same one that would apply when companies request confidential treatment of trade secrets and

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commercial or financial information that otherwise must be disclosed in registration statements, periodic reports and other documents filed with the SEC. Similarly, to the extent a performance target has otherwise been disclosed publicly, disclosure under Item 402 would be required.

The CD&A will be considered a part of the proxy statement and any other filing in which it is included. Unlike the current compensation committee report and performance graph, which are to be eliminated, the CD&A would be soliciting material and would be filed with the Commission. Therefore, it would be subject to Regulations 14A or 14C and to the liabilities of Section 18 of the Exchange Act. In addition, to the extent that the CD&A is included or incorporated by reference into a periodic report, the disclosure would be covered by the certifications that principal executive and financial officers must make under the Sarbanes-Oxley Act.

Compensation tables

The SEC would reorganize and streamline the compensation tables into three broad categories to clearly and logically provide a picture of total compensation and its elements for named executive officers. See Release No. 33-8655, Part II.B.

The first category is compensation for the last fiscal year and the two preceding fiscal years as reflected in a revised summary compensation table. Note that current instructions to Item 402(b), permitting exclusion of information for fiscal years prior to the last completed fiscal year if the company was not a reporting company at any time during that year, would be retained and redesignated as proposed Instruction 1 to Item 402(c).

The table would present compensation paid currently or deferred, including options, restricted stock and similar grants, and compensation consisting of current earnings or awards that are part of a plan. It will be supplemented by two tables providing back-up information on performance-based awards and grants of all other equity awards. Narrative disclosure would follow the three tables, providing disclosure of material information necessary to an understanding of the information disclosed in the tables.

A new column in the summary compensation table would require disclosure of total compensation comprising the aggregate total dollar value of each form of compensation quantified in the columns that follow it. This mandate is designed to satisfy the concerns of investors and analysts that current disclosure leaves them unable to accurately compute aggregate amounts of compensation. When compensation is paid in a currency other than the dollar, footnote disclosure must identify the currency and describe the rate and methodology used for conversion to dollars.

The next proposed columns in the summary compensation table are the salary and bonus columns, which would be retained substantially in their current form. However, some changes have been proposed to give a clearer picture of the total amount earned, the amount deferred for the year, and the total amount of deferred compensation that may be paid out at a later date.

Compensation that is earned, but for which payment will be deferred, would be included in the salary, bonus or other column, as appropriate. A new instruction, applicable to the entire summary compensation table, would provide that, if receipt of

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any amount of compensation is currently payable but has been deferred for any reason, the amount so deferred must be disclosed in a footnote to the applicable column. Currently, this requirement is triggered only if the officer elects the deferral. The proposal covers all deferrals no matter who has initiated them. The amount deferred would generally be reflected as a contribution in the deferred compensation presentation.

Also proposed is the elimination of the current delay when salary and bonus for the most recent fiscal year are determined following compliance with Item 402 disclosure. Under the proposal, when salary and bonus cannot be calculated as of the most recent practicable date, a current report under Item 5.02 of Form 8-K would be triggered by a payment, decision or other occurrence as a result of which such amounts become calculable in whole or part. The Form 8-K would include disclosure of the salary or bonus amount and a new total compensation figure including that salary or bonus amount.

Currently, in the event that such amounts are not determinable at the most recent practicable date, they are generally reported in the annual report on Form 10-K or proxy statement for the following fiscal year. The SEC believes that providing the information more quickly is appropriate and is proposing the use of a current report on Form 8-K. Proposed Instruction 1 to Item 402(c)(2)(iv) and (v) would require that the company disclose in a footnote that the salary or bonus is not calculable through the latest practicable date and the date that the salary or bonus is expected to be determined.

The next three proposed columns in the summary compensation table cover plan-based awards, such as stock awards, option awards and non-stock incentive plan compensation.

The stock awards column would disclose 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, phantom stock, common stock equivalent units or other similar instruments that do not have option-like features. If such awards include option-like features, they would be included in the option awards column.

In order to consolidate related elements of compensation, the stock awards and option awards columns would also require disclosure of the earnings on outstanding awards in the respective categories. New instructions would require footnote identification and quantification of all earnings, whether the earnings were paid during the fiscal year, payable during the period but deferred, or payable by their terms at a later date but earned during the year.

Another column in the summary compensation table would deal with non-stock incentive plan compensation, which would report the dollar value of all other amounts earned during the fiscal year pursuant to incentive plans. This column would be limited to awards where the relevant performance measure under the incentive plan is not based on the price of the company's equity securities or the award may not be settled by issuance of a company's equity securities. Incentive compensation not tied to the performance of the company's stock could involve performance tied to other measures, such as a return on assets, return on equity, or performance of a division of the company.

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The final column in the summary compensation table would disclose all other compensation not required to be included in any other column. Each item of compensation included in the all other compensation column that exceeds $10,000 must be separately identified and quantified in a footnote. The only exception to this de minimis rule is for perquisites for a named executive. Each item of compensation less than that amount would be included in the column but would not be required to be identified by type and amount.

The SEC would require disclosure in this catch-all column of all earnings on compensation that is deferred on a basis that is not tax-qualified, including non-tax qualified defined contribution retirement plans. Currently, these earnings must be disclosed only to the extent of any portion that is above-market or preferential.

Separate footnote identification and quantification of all such earnings would be required if the amount exceeds $10,000. A company would be permitted to identify by footnote the portion of any earnings that it considered to be paid at an above market rate provided that the footnote explained the company's criteria for determining the portion considered to be above market.

Similarly, the all other compensation column would require disclosure of the aggregate of increase in actuarial value to the executive officer of defined benefit and actuarial plans accrued during the year. An instruction would specify that this disclosure applies to each plan that provides for the payment of retirement benefits, or benefits that will be paid primarily following retirement, including but not limited to tax-qualified defined benefit plans and supplemental employee retirement plans, but excluding defined contribution plans.

Perquisites and other personal benefits would have to be included in the all other compensation column unless the aggregate amount of such compensation is less than $10,000. The SEC believes that $10,000 is a reasonable balance between investors' need for disclosure of total compensation and the burden on a company to track every benefit, no matter how small. The current provision permits omission of perquisites and other personal benefits if the aggregate amount of such compensation is the lesser of either $50,000 or 10% of the total of annual salary and bonus. The current rule permits the omission of too much information that investors may consider material.

The SEC would mandate footnote disclosure identifying perquisites and other personal benefits. The SEC would modify the current requirement that only perquisites and other personal benefits that are 25% of the total amount for each named executive officer must be identified and quantified. Under the proposal, unless the aggregate value of perquisites and personal benefits is less than $10,000, any perquisite or other personal benefit is identified and, if it is valued at the greater of $25,000 or ten percent of total perquisites and other personal benefits, its value would be disclosed.

Consistent with the objective of streamlining the summary compensation table, the revised threshold is intended to avoid requiring separate quantification of perquisites having de minimis value. As is the case today, tax grossups or other reimbursement of taxes owed with respect to any compensation, including but not limited to perquisites and other personal benefits, would be separately quantified and identified in the tax reimbursement category, even if the associated perquisites or other personal benefits are

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eligible for exclusion or would not require identification or footnote quantification under the proposal. When perquisites are subject to identification, they must be described in a manner that identifies the particular nature of the benefit received. For example, it is not sufficient to characterize generally as travel and entertainment different company-financed benefits, such as clothing, jewelry, artwork, theater tickets and housekeeping services.

Guidance on perquisites

Although the SEC declined to define "perquisite," fearing such a definition would become outdated, the Commission did advise that perquisites and personal benefits should not be interpreted narrowly to avoid disclosure. In addition, based on its long experience with disclosure in this area, the SEC provided interpretive guidance on the factors to be considered in determining whether an item is a perquisite or other personal benefit. For example, an item is not a perquisite if it is integrally and directly related to the performance of the executive's duties, otherwise it is a perquisite if it confers a benefit that has a personal aspect without regard to whether it may be provided for some business reason or for the company's convenience, unless it is available on a non-discriminatory basis to all employees.

In the SEC's view, the concept of a benefit that is integrally and directly related to job performance is a narrow one. The concept may extend to office space at a company business location, a reserved parking space that is closer to business facilities but not otherwise preferential, or to additional clerical or secretarial services devoted to company matters. But it does not extend to items that facilitate job performance, such as use of company-provided aircraft, yachts or other watercraft, commuter transportation services, additional clerical or secretarial services devoted to personal matters, or investment management services.

Moreover, the fact that the company has determined that an expense is an ordinary or necessary business expense for tax or other purposes, or that an expense is for the benefit or convenience of the company, is not responsive to the inquiry as to whether the expense provides a perquisite for disclosure, which is triggered by different and broader concepts.

Applying these concepts, the SEC cited examples of items requiring disclosure as perquisites: 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 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, and discounts on the company's products or services not generally available to employees on a non-discriminatory basis.

In addition, business purpose or convenience does not affect the characterization of an item as a perquisite where it is not integrally and directly related to the executive's job performance. Therefore, for example, a company's decision to provide an item of personal benefit for security purposes does not affect its characterization as a perquisite. A company policy that for security purposes an executive must use company aircraft or

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other company means of travel for personal travel, or must use company or company-provided property for vacations, does not affect the conclusion that the item provided is a perquisite.

Examples of items that would not be perquisites or personal benefits would include, among other things, travel to and from business meetings, other business travel, business entertainment, security during business travel, and itemized expense accounts the use of which is limited to business purposes.

Moreover, an office at the job location, even if larger than that of other employees, is integrally and directly related to performance of the executive's job, as is secretarial service used for business purposes, even if at a higher level than other employees. On the other hand, provision of additional secretarial services, such as a second secretary, that is not directly related to performance of an executive's job, would be a perquisite.

Other items to be included in the all other compensation column are: amounts paid under a plan in connection with any termination of employment or a change in control; annual company contributions to defined contribution plans; the dollar value of insurance premiums paid by the company with respect to life insurance for the benefit of a named executive officer; gross-up or other amounts reimbursed during the fiscal year for the payment of taxes; and for any security of the company purchased from the company at a discount from market price unless the discount is also available to all shareholders or to all salaried employees.

For any compensation as a result of a business combination, other than pursuant to a plan in connection with any termination of employment or change-in-control, such as a retention bonus, acceleration of option or stock vesting periods, or performance-based compensation intended to serve as an incentive for named executive officers to acquire other companies or enter into a merger agreement, disclosure would be required in the appropriate summary compensation table column and in the other tables or narrative disclosure where the particular element of compensation must be disclosed.

Two supplemental tables would follow the summary compensation table. The first table would include information regarding non-stock grants of incentive plan awards, stock-based incentive plan awards and awards of options, restricted stock and similar instruments under plans that are performance-based and thus provide the opportunity for future compensation if conditions are satisfied

The second table would show the equity-based compensation awards granted in the last fiscal year that are not performance-based, such as stock, options or similar instruments where the payout or future value is tied to the company's stock price, and not to other performance criteria. Instructions would require options and stock appreciation rights granted in connection with a repricing transaction to be included in this table, and footnote descriptions of any material terms of a grant.

Narrative disclosure would be required to give context to the tabular disclosure following the summary compensation table, and the supplemental tables. The narrative would describe any additional material factors necessary to an understanding of the information disclosed in the tables. In this context, the SEC expressly endorsed the

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standard of materiality crafted by the Supreme Court in the *Basic v. Levinson* and *TSC Industries v. Northway* opinions.

Unlike the CD&A, which would focus on broader topics regarding the objectives and implementation of executive compensation policies, this narrative disclosure would focus on the quantitative disclosure in the tables. The material factors will vary depending on the facts, but may include descriptions of the material terms in the named executive officers' employment agreements, which may be a potential source of material information necessary to an understanding of the tabular disclosure. The proposed narrative disclosure would cover written or unwritten agreements.

Requiring this disclosure in proximity to the summary compensation table is intended to make the tabular disclosure more meaningful. Mere filing of employment agreements or summaries of oral agreements may not be adequate to disclose material factors depending on the circumstances.

The factors that could be material include each repricing or other material modification of any outstanding option or other stock-based award during the last fiscal year. This disclosure would address not only options repricings, but also other significant changes to the terms of stock-based or other awards.

The SEC proposes to eliminate the current ten-year option repricing table. In its place, the narrative disclosure following the summary compensation table would describe, to the extent material and necessary to an understanding of the tabular disclosure, 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. The tabular disclosure would reflect the award's total fair value after any such modification as a new award.

Narrative text accompanying the tables would also describe, to the extent material and necessary to an understanding of the tabular disclosure, award terms relating to data provided in the grants of performance-based awards table, which could include a general description of the formula 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, whether dividends or other amounts would be paid, the applicable rate and whether that rate is preferential.

Consistent with current disclosure requirements, however, companies would not be required to disclose any factor, criteria, or performance-related or other condition to payout or vesting of a particular award that involves confidential commercial or business information, disclosure of which would adversely affect the company's competitive position.

Another factor that may be necessary to an understanding of the information disclosed in the tables is any material waiver or modification of any specified performance target, or condition to payout under any reported incentive plan payout because each action can materially affect previously disclosed information about the plans. Companies would be required to disclose as part of this narrative discussion

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whether the waiver or modification applied to one or more specified named executive officers or applied to all compensation subject to the condition.

Material factors necessary to an understanding of the tabular disclosure could also include information regarding defined benefit and deferred compensation plans. For example, such information could include material assumptions underlying the determination of the amount of increase in actuarial value of defined benefit or actuarial plans or the provisions in a plan for determining earnings on deferred compensation plans, including defined contribution plans, that are not tax-qualified.

An additional item would require disclosure for up to three employees who were not executive officers during the last competed fiscal year and whose total compensation for the last completed fiscal year was greater than that of any of the named executive officers. The item would require disclosure of the amount of each of such employee's total compensation for the most recent fiscal year and a description of his or her job position. The individuals would not need to be named.

This requirement was added so that shareholders will have information about the use of corporate assets to compensate extremely highly paid employees in a company. More detailed information about these employees and their compensation does not appear appropriate in light of the fact that they do not have a policy making function at the company.

Exercises of previously-awarded equity

The second broad category of executive compensation disclosure would provide investors with an understanding of compensation in the form of equity that has previously been awarded and remains unexercised or unvested. See Release No. 33-8655, Part II.B.4. This section also would disclose amounts realized on this type of compensation during the most recent fiscal year when, for example, an executive officer exercises an option or his or her stock award vests.

Two tables are proposed: one showing the amounts of prior awards outstanding; the other showing the exercise or vesting of equity awards during the fiscal year.

The first table covers outstanding awards that have been granted but the ultimate outcomes of which have not yet been realized, which in effect represent potential amounts that the executive officer might or might not realize, depending on the outcome for the measure to which the award relates, such as stock price or performance benchmarks.

The table would disclose information regarding outstanding awards under, for example, stock option or stock appreciation rights plans, restricted stock plans, incentive plans and similar plans and disclose the market-based values of the options, rights, shares or units in question as of the company's most recent fiscal year end.

With respect to options and stock appreciation rights and similar instruments, an instruction would indicate that these instruments are in-the-money if the market price of the underlying securities exceeds the exercise or base price. The in-the-money amount of options and stock appreciation rights would be calculated by determining the difference, at fiscal year-end, between the market price of the underlying securities and the exercise

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or base price. The market value of stock, including restricted stock, and incentive plan award holdings would be calculated by multiplying the closing market price of the company's stock at the end of the last completed fiscal year by the respective numbers of stock or incentive plan award holdings that were not then vested.

A new instruction would require footnote disclosure of the expiration dates of options, stock appreciation rights and similar instruments held at fiscal year-end, separately identifying those that are exercisable and unexercisable, and the vesting dates of shares of stock, including restricted stock, and incentive plan awards held at fiscal year-end. If the expiration date of an option had occurred after fiscal year-end but before the date on which the disclosure is made, the footnote would need to state whether the option had been exercised or had expired.

The second table would show the amounts received upon exercise of options or the vesting of stock during the most recent fiscal year, thus giving investors a picture of the amounts that a named executive officer realizes on equity compensation through its final stage. Since the grant date fair value of these instruments would have been disclosed in the summary compensation table for the year in which they were awarded, this table would show that amount from applicable previous years from the summary compensation table.

Post-employment compensation

The third broad category of executive compensation disclosure is post-employment compensation. See Release No. 33-8655, Part II.B.5. A separate category is appropriate since executive retirement packages and other post-termination compensation may represent a significant commitment of corporate resources and a significant portion of overall compensation.

The SEC proposes to replace the current pension plan table, alternative plan disclosure and some of the other narrative descriptions with a table on defined benefit pension plans and enhanced narrative disclosure. Additionally proposed is a table and narrative disclosure that will provide information on non-qualified defined contribution plans and other deferred compensation. Finally, the Commission proposes revised requirements regarding disclosure of compensation arrangements triggered upon termination and on changes in control.

New rules would require disclosure of the estimate of retirement benefits to be payable at normal retirement age and, if available, early retirement. Current disclosure frequently does not provide investors useful information regarding specific potential pension benefits and makes it difficult for the reader to understand which amounts relate to any particular named executive officer, thus obscuring the value of a significant component of compensation.

Thus, the SEC proposes a new table disclosing estimated annual retirement payments under defined benefit plans for each named executive officer, followed by narrative disclosure. A separate line of tabular disclosure would be required for each plan in which an executive officer participates that provides for the payment of specified retirement benefits, or benefits that will be paid primarily following retirement. These would include, but not be limited to, tax-qualified defined benefit plans, supplemental employee

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retirement plans and cash balance plans, but would exclude defined contribution plans, for which other disclosure is proposed.

An instruction would provide that quantification of benefits should reflect the form of benefit currently elected by the executive officer, such as joint and survivor annuity or single life annuity, specifying that form in a footnote. Where the named executive officer is not yet eligible to retire, the dollar amount of annual benefits to which he or she would be entitled upon becoming eligible would be computed assuming that the officer continued to earn the same amount of compensation as reported for the company's last fiscal year. If the executive officer left during the year, the dollar amounts of annual benefits to which he or she would be entitled would be required to be disclosed.

Normal retirement age would mean 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. If the credited years of service for the executive under any plan differ from the actual years of service with the company, a footnote quantifying the difference and any resulting benefit increase would be required.

The table would be followed by a narrative description of material factors necessary to an understanding of each plan disclosed in the table. Examples of such factors in the proposed rule 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;
- if the executive or company may elect a lump sum distribution, the amount of such distribution that would be available on election as of the end of the company's last fiscal year, disclosing the valuation method and material assumptions applied in quantifying such amount;
- 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 reasons for each plan; and
- company policies with regard to such matters as granting extra years of credited service.

Another proposed table would require disclosure of contributions, earnings and balances under nonqualified defined contribution and other deferred compensation plans. An instruction would require footnote quantification of the extent to which amounts in the contributions and earnings columns are reported as compensation in the year in question and other amounts reported in the table in the aggregate balance column were reported previously in the summary compensation table for prior years. This would complement the proposed instruction to the summary compensation table that would require footnote disclosure of amounts for which receipt has been deferred. Together, these footnotes would operate to provide information so that investors can avoid double counting of deferred amounts by clarifying the extent to which amounts payable as deferred compensation represent compensation previously reported, rather than additional currently earned compensation.

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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 in the proposed rule include:

- the type(s) of compensation permitted to be deferred, and any limitations 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 executive officer 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
- material terms with respect to payouts, withdrawals and other distributions.

Other potential post-employment payments

The Commission has long recognized that termination provisions are distinct from other plans in both intent and scope and are of particular interest to shareholders. Currently, disclosure often does not capture material information regarding these plans and potential payments under them.

Thus, the SEC proposes disclosure of specific aspects of any written or unwritten arrangement providing for payments at, following, or in connection with the resignation, severance, retirement or other termination of executive officers, a change in their duties, or a change in control of the company. There would be a narrative disclosure of 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 payment or provision of benefits;
- any material conditions or obligations applicable to the receipt of payments or benefits, including non-compete, non-solicitation, non-disparagement or confidentiality covenants; and
- any other material features necessary for an understanding of the provisions.

With regard to the disclosure of estimated payments and benefits on termination, the SEC proposes to eliminate the current $100,000 disclosure threshold. With respect to post-termination perquisites, however, the same disclosure and itemization thresholds proposed for the summary compensation table would apply.

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This item contemplates the 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.

As proposed, a company would have to provide quantitative disclosure under these requirements even when 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.

Officers covered by executive compensation rules

Currently, the named executive officers for whom disclosure is required include the company's chief executive officer and the four most highly compensated executive officers excluding the CEO. The SEC proposes that the named executive officers would be the principal executive officer, the principal financial officer and the three most highly compensated executive officers other than the principal executive and financial officers. See Release No. 33-8655, Part II.B.6. In addition, as is currently the case, up to two additional individuals for whom disclosure would have been required but for the fact that they were no longer serving as executive officers at the end of the last completed fiscal year would be included.

The SEC believes that compensation of the principal financial officer is important to shareholders because, along with the principal executive officer, the principal financial officer provides the certifications required with the company's periodic reports and has important responsibility for the fair presentation of the company's financial statements. Like the principal executive officer, disclosure about the principal financial officer would be required even if he or she was no longer serving in that capacity at the end of the last completed fiscal year.

As is currently the case for the CEO, all persons who served as the company's principal executive officer or principal financial officer during the last completed fiscal year would be named executive officers.

While the Commission adopted the nomenclature of Item 5.02 of Form 8-K with regard to principal executive officer and principal financial officer, the SEC is not proposing to require compensation disclosure for all of the officers listed in Item 5.02. This item was adopted to provide current disclosure in the event of an appointment, resignation, retirement or termination of the specified officers based on the principle that changes in employment status of these particular officers are unquestionably or presumptively material. At the time when a decision is made regarding the employment status of a particular officer, it will not always be clear who will be the named executive officers for the current year. Given these factors, it is reasonable for the two groups not to be identical.

The SEC proposed to identify the most highly compensated executive officers on the basis of total compensation for the most recent fiscal year. Also proposed is a revision of the dollar threshold for disclosure of named executive officers other than the principal

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executive officer and the principal financial officer to $100,000 of total compensation for the last fiscal year.

Both the determination of the most highly compensated officers and the $100,000 disclosure threshold are currently based only on total annual salary and bonus for the last fiscal year. Given the proliferation of various other forms of compensation, the SEC believes that total compensation more accurately identifies those officers who are, in fact, the most highly compensated. Moreover, basing identification of named executive officers solely on the compensation reportable in the salary and bonus categories may provide an incentive to re-characterize compensation.

Under the current rules, companies are permitted to exclude an executive officer, other than the CEO, due to either an unusually large amount of cash compensation that is not part of a recurring arrangement and is unlikely to continue, or cash compensation relating to overseas assignments attributed predominantly to such assignments.

Because payments attributed to overseas assignments have the potential to skew the application of Item 402 disclosure away from executives whose compensation otherwise properly would be disclosed, the SEC proposes to retain this basis for exclusion. However, the Commission believes that other compensation that is not recurring and unlikely to continue should be considered compensation for disclosure purposes. Since there has been inconsistent interpretation of the not recurring and unlikely to continue standard, and it is susceptible to manipulation, the SEC would eliminate this basis for exclusion.

Interplay of Items 402 and 404

As proposed, Item 402 would require disclosure of all transactions between the company and a third party where the primary purpose of the transaction is to furnish compensation to a named executive officer. See Release No. 33-8655, Part II.B.7. While Item 402 states that such compensation is reportable, even if also called for by another requirement, Item 402 also provides that information may be excluded if a transaction has been reported in response to Item 404. This provision may cause Item 402 disclosure to omit compensation that a transaction disclosed under Item 404 provides to executives.

The SEC proposes to eliminate that exclusion from Item 402. Proposed instructions to Item 404 would clarify what compensation does not need to be reported under Item 404. In some cases the result may nevertheless be that compensation information is disclosed under Item 402 while a related person transaction giving rise to that compensation is disclosed under Item 404. The Commission believes the possibility of additional disclosure in the context of each of the respective items is preferable to the possibility that compensation is not properly and fully disclosed under Item 402.

Other proposed changes

A company is currently permitted to omit from Item 402 disclosure information regarding group life, health, hospitalization, medical reimbursement or relocation plans that do not discriminate in scope, terms or operation, in favor of executive officers or directors of the company and that are available generally to all salaried employees.

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Because relocation plans, even when available to all salaried employees, are susceptible to operation in a discriminatory manner that favors executive officers, this exclusion may deprive investors of disclosure of significant compensatory benefits. Thus, the SEC proposes to delete relocation plans from this exclusion. See Release No. 33-8655, Part II.B.8. For the same reason, relocation plans would be deleted from the exclusion from portfolio manager compensation in forms used by management investment companies to register under the Investment Company Act and offer securities under the Securities Act.

Compensation of directors

Director compensation has evolved from simple cash compensation and attendance fees to more complex packages involving share-based compensation, incentive plans and other forms of compensation. In light of this complexity, the SEC proposes formatted tabular disclosure for director compensation, accompanied by narrative disclosure of additional material information. See Release No. 33-8655, Part II.B.9.

The proposed director compensation table would resemble the proposed summary compensation table, but would present information only with respect to the company's last completed fiscal year. The table would have columns for fees paid in cash, stock awards, option awards, non-stock incentive plans, and a catch-all column for all other compensation. The "all other" compensation column 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 to defined contribution plans;
- company stock purchased from the company at a discount from the market price unless the discount is available to all shareholders or to all salaried employees;
- aggregate annual increase in actuarial value of all defined benefit and actuarial pension plans;
- all consulting fees;
- awards under director legacy or charitable awards programs; and
- the dollar value of any insurance premiums paid by the company for life insurance for the director's benefit.

With regard to director legacy programs, also known as charitable award programs, companies typically agree to make a future donation to one or more charitable institutions in the director's name, payable upon a designated event such as death or retirement. The amount to be disclosed in the table would be the annual cost of such promises and payments, with footnote disclosure of the total dollar amount and other material terms of each such program.

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

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outstanding equity awards at fiscal year end as would be required if the outstanding equity awards table for named executive officers were required for directors.

The same instructions as provided in the summary compensation table would govern analogous matters in the director compensation table. As with the summary compensation table, the proposed rules clarify that all compensation must be included in the table. As is the case with the current director disclosure requirement, companies would not be required to include in the director disclosure any amounts of compensation paid to a named executive officer and disclosed in the summary compensation table with footnote disclosure indicating what amounts reflected in that table are compensation for services as a director.

A proposed instruction to the director compensation table would permit the grouping of directors in a single row of the table if all of their elements and amounts of compensation are identical.

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. The SEC is not proposing supplemental tables for directors.

Small business issuers

The executive compensation proposals would continue to differentiate between small business issuers and other issuers. See Release No. 33-8655, Part II.C.1. In crafting the proposals, the SEC recognized that the executive compensation arrangements of small business issuers typically are less complex than those of other public companies.

As proposed, small business issuers would be required to provide, along with related narrative disclosure: the summary compensation table; the outstanding awards at fiscal year-end table; and the director compensation table. Small business issuers would only be required to provide information in the summary compensation table for the last two fiscal years. In addition, they would be required to provide information for fewer named executive officers: the principal executive officer and the two most highly compensated officers other than the principal executive officer. Narrative discussion of a number of items to the extent material would replace tabular or footnote disclosure, for example identification of other items in the all other compensation column and a description of post-employment payments and other benefits. Further, small business issuers would not be required to provide a CD&A.

Foreign private issuers

Currently, foreign private issuers are in compliance with Item 402 if they provide the information required by Form 20-F, with more detailed information if otherwise made publicly available. The SEC proposes to continue this treatment of foreign private issuers and clarify that their treatment under Item 402 parallels that under Form 20-F. See Release No. 33-8655, Part II.C.2.

Business development companies

The SEC proposes to apply the same executive compensation disclosure requirements to business development companies that it is proposing for operating companies. See

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Release No. 33-8655, Part II.C.3. Business development companies are a category of closed-end investment companies that are not required to register under the Investment Company Act.

Currently, business development companies must provide executive compensation disclosure based, in part, on the requirements that apply to operating companies and, in part, on the requirements that apply to registered investment companies. Moreover, the executive compensation disclosure requirements for business development companies are not uniform in Securities Act registration statements, proxy and information statements, and Form 10-K. Under Form 10-K, business development companies must furnish all of the information required by Item 402 for all of the persons covered by the Item.

In proxy and information statements, business development companies must provide for directors and each of the three highest paid officers that have aggregate compensation from the company for the most recently completed fiscal year in excess of $60,000, certain information required by Item 402 and certain other information that registered investment companies must provide.

In registration statements, business development companies must provide the same information required in proxy statements, but with respect to directors, members of the advisory board, and each of the three highest paid officers or any affiliated person of the company that have aggregate compensation from the company for the most recently completed fiscal year in excess of $60,000.

The SEC proposes to apply to business development companies the same executive compensation rules that apply to operating companies because the proposed disclosure requirements are intended to provide investors with a clearer and more complete picture of executive compensation, and the Commission fears that this purpose would not be achieved through piecemeal application of some of the requirements.

The proposal would also eliminate the current inconsistency between Form 10-K, on the one hand, which requires business development companies to furnish all of the information required by Item 402, and the proxy rules and Form N-2, on the other, which require business development companies to provide some of the information from Item 402 and other information that applies to registered investment companies.

The SEC also believes that, similar to operating companies, business development companies should furnish compensation disclosure on proxies relating to the compensation arrangements and other matters enumerated in Items 8(b) through (d) of Schedule 14A and not just in the case of director elections as currently required.

Under the proposals, the registration statements of business development companies would be required to include all of the disclosures required by Item 402 for all of the persons covered by Item 402. This disclosure would also be required in the proxy and information statements of business development companies if action is to be taken with respect to the election of directors or with respect to the compensation arrangements and other matters enumerated in Items 8(b) through (d) of Schedule 14A. Business development companies would also be required to make these disclosures in their annual reports on Form 10-K.

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As a result of these proposed changes, the persons covered by the compensation disclosure requirements would be changed. The compensation disclosure in the proxy and information statements and registration statements of business development companies would be required to cover the same officers as for operating companies, including the principal executive officer and principal financial officer, as well as the three most highly compensated executive officers that have total compensation exceeding $100,000, instead of each of the three highest paid officers of the company that have aggregate compensation from the company for the most recently completed fiscal year in excess of $60,000.

In addition, the registration statements of business development companies would no longer be required to disclose compensation of members of the advisory board or certain affiliated persons of the company. Finally, under the proposals, the proxy and information statements and registration statements of business development companies would not be required to include compensation from the fund complex. Currently, this information is required in some circumstances.

Form 8-K Changes

Form 8-K requires disclosure of the entry into, amendment of and termination of material definitive agreements outside the ordinary course of business. Under current definitions in Regulation S-K, many agreements regarding executive compensation are deemed to be material agreements entered into outside the ordinary course, and when for purposes of consistency those definitions were used in the expanded Form 8-K requirements, the SEC incorporated all of these executive compensation agreements into the current Form 8-K disclosure requirements.

Therefore, many agreements regarding executive compensation must be disclosed within four business days of the applicable triggering event. Because it was not the intent in adopting the expanded Form 8-K requirements to make all elements of compensation for all executive officers potential items of real-time disclosure, but only to capture events that are unquestionably or presumptively material to investors, the SEC believes it is appropriate to modify the rules so that only those material events must be disclosed on Form 8-K. See Release No. 33-8655, Part III.A.

Item 1.01 of Form 8-K currently requires disclosure, within four business days, of the company's entry into a material definitive agreement outside of its ordinary course of business, or any amendment of such agreement that is material to the company. Item 1.01 has resulted in executive compensation disclosures that are much more frequent and accelerated than those included in a company's proxy statement.

The SEC proposes to amend Item 1.01 to eliminate employment compensation arrangements and to cover such arrangements under a modified and broader Item 5.02. Item 5.02 currently requires disclosure within four business days of the appointment or departure of directors and specified officers. In particular, Item 5.02 requires disclosure if a company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions, retires, resigns or is terminated from that position or if a company appoints a

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new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions. Similarly, Item 5.02 also requires disclosure if a director retires, resigns, is removed, or declines to stand for re-election. The required disclosure currently includes a brief description of the material terms of any employment agreement between the company and the officer and a description of disagreements, if any.

The SEC proposes to modify Item 5.02 to capture the currently required information under that item, as well as additional information regarding material employment compensation arrangements involving named executive officers that currently fall under Item 1.01. See Release No. 33-8655, Part III.B. The proposal modifies the overall requirements for disclosure of employment compensation arrangements, and locates all such disclosure under a single item. This would be accomplished by:

- expanding the information regarding retirement, resignation or termination to include all persons falling within the definition of named executive officers for the company's previous fiscal year;
- expanding the disclosure items covered under Item 5.02 beyond employment agreements to require a brief description of any material plan, contract or arrangement to which a covered officer or director is a party or in which he or she participates that is entered into, or materially amended, in connection with any of the triggering events specified in Item 5.02, or any grant or award to any such covered person, or modification thereto, under any such plan in connection with any such event;
- in respect of the principal executive officer, the principal financial officer, or persons falling within the definition of named executive officer for the company's previous fiscal year, expanding the disclosure items to include a brief description of any material new compensatory plan or arrangement, or new grant or award thereunder (whether or not written), and any material amendment to any compensatory plan or arrangement (or any modification to a grant or award thereunder), whether or not such occurrence is in connection with a triggering event specified in Item 5.02. Grants or awards will not be required to be disclosed if they are consistent with the terms of previously disclosed plans or arrangements and they are disclosed the next time the company must provide new disclosure under Item 402; and
- adding a requirement for disclosure of salary and bonus for the most recent fiscal year that was not available at the latest practicable date in connection with disclosure under Item 402.

In the case of each of these disclosure items proposed for Item 5.02, the SEC emphasized that it is proposing that a brief description of the specified matter be included. In response to the current requirement under Item 1.01, some companies have included disclosure that resembles an updating of the disclosure required under current Item 402. In the context of current disclosure under Form 8-K, the Commission seeks a disclosure that informs investors of specified material events and developments. However, the information the SEC seeks does not perforce extend to the information necessary to comply with Item 402.

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Related-Party Transaction Disclosure

The SEC also proposes to significantly revise the rules concerning related-party transactions. See Release No. 33-8655, Part V.A. The vehicle for change is an amended Item 404 of Regulation S-K designed to streamline and modernize this disclosure requirement, while making it more principles-based.

Although the proposals would significantly modify this disclosure requirement, the purpose of eliciting disclosure regarding transactions and relationships, including indebtedness, involving the company and related persons and the independence of directors and nominees for director and the interests of management would remain unchanged.

Proposed Item 404(a) would consist of a general statement of the principle for disclosure, followed by specific disclosure requirements and instructions. The instructions would explain the related persons covered by the Item, the scope of transactions covered by the Item, the method for computation of the amounts involved in the relationship or transaction, the interaction with Item 402, special requirements for indebtedness with banks, and the materiality of certain ownership interests.

The proposed Item would extend to disclosure of indebtedness. Currently, Item 404(a) requires disclosure regarding transactions involving the company and related persons, and Item 404(c) requires disclosure regarding indebtedness. The SEC would consolidate these two provisions in order to eliminate confusion regarding the circumstances in which each item applies and streamline duplicative portions of Item 404.

Broad principle for disclosure

Item 404(a) would articulate a broad principle for disclosure; stating that a company must provide disclosure regarding: any transaction or proposed transaction in which the company is a participant, that involves an amount exceeding $120,000, and in which a related person has a material interest. See Release No. 33-8655, Part V.A.1.

The SEC proposes to eliminate current Instruction 1 to Item 404(a), which it views as repetitive of the general materiality standard applicable to the item. By proposing to delete this instruction, however, the SEC does not intend to change the materiality standard.

The materiality standard for disclosure currently embodied in Item 404(a) would be retained. Thus, a company would disclose based on whether the related person has a direct or indirect material interest in the transaction. The materiality of any interest would continue to be determined on the basis of the significance of the information to investors in light of all the circumstances and the significance of the interest to the person having the interest, which is the general materiality standard enunciated by the US Supreme Court. The relationship of the related persons to the transaction, and with each other, and the amount involved in the transaction would be among the factors to be considered in determining the materiality of the information to investors.

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Also poised for elimination is current Instruction 7 to Item 404(a), which establishes presumptions regarding materiality and may operate to exclude some transactions from disclosure that might otherwise require disclosure under the principles enunciated by the Item. Also slated for elimination is current Instruction 9 to Item 404(a), which indicates that the $60,000 threshold is not a bright line materiality standard.

In addition, the proposals would call for disclosure if a company is a participant in a transaction, rather than if it is a party to the transaction, since the term participant more accurately connotes the company's involvement. The new rules would also raise the threshold for disclosure to $120,000.

The SEC emphasized that the current $60,000 threshold is not, and the proposed $120,000 threshold would not be, a bright line materiality standard. The rules call for, and would continue to call for, a materiality analysis of transactions above the threshold in order to determine if the related person has a direct or indirect material interest.

As is currently the case, disclosure would be required for three years in registration statements filed pursuant to the Securities Act or the Exchange Act. However, if the disclosure were being incorporated by reference into a registration statement on Form S-4, the additional two years of disclosure would not be required.

Section 402 of the Sarbanes-Oxley Act prohibits most personal loans by the company to its officers and directors. This development raises the issue of whether disclosure of indebtedness of the sort required under the current rules should be maintained. The SEC believes that the proposed approach to disclosure of indebtedness involving related persons would be appropriate because of the scope of the direct and indirect interests covered by the disclosure requirements, because related persons include persons not covered by the prohibition, and because there are certain exceptions to the loan prohibition. The SEC does propose, however, to eliminate the current distinction between indebtedness and other types of related person transactions.

As a result of integrating paragraph (c) of Item 404 into paragraph (a) of the Item, the proposals would change some situations in which indebtedness disclosure is required. First, disclosure of indebtedness transactions would be required with regard to all related persons covered by the related person transaction disclosure requirement, including significant shareholders. The related person disclosure requirement in current Item 404(a) covers significant shareholders, while the indebtedness disclosure requirement in current Item 404(c) does not. The significant shareholders covered would continue to be any shareholder who is known to the company to own of record or beneficially more than five percent of any class of the company's voting securities.

Second, the rule proposals would require disclosure of all indirect interests in indebtedness transactions of related persons, including significant shareholders and immediate family members. As a result of integrating paragraph (c) of Item 404 into paragraph (a), the rule proposals would set a $120,000 threshold and require disclosure only if there is a direct or indirect material interest in such an indebtedness transaction, while Item 404(c) currently generally requires disclosure of all indebtedness exceeding $60,000.

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Disclosure of material indirect interests of these related persons in transactions involving the company currently is, and would continue to be, required by Item 404(a). Currently, Item 404(c) requires disclosure of specific indirect interests of directors, nominees for director, and executive officers of the company in indebtedness through corporations, organizations, trusts, and estates. The SEC believes that disclosure requirements for indebtedness and for other related person transactions should be congruent. In particular, loans by companies other than financial institutions should be treated like any other related person transaction, and, the Commission proposes to address ordinary course loans by financial institutions in an instruction to Item 404(a)

The terms "transaction," "related person" and "amount involved" would be defined in a way that clarifies the broad scope of financial transactions and relationships covered by Item 404(a). The term "transaction" would broadly include any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships. The proposals specifically note that the term transaction includes indebtedness and guarantees of indebtedness.

The proposed definition of "related person" would identify the persons covered, and clarify the time periods during which they would be covered. Related person means directors or executive officers and their immediate family members. If disclosure was provided in a proxy or information statement involving the election of directors, the nominees for director and their immediate family members are related persons.

Under the rule proposals, the term "immediate family member of a related person" would mean 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.

The proposed definition of "amount involved" would incorporate two concepts included in current Item 404 regarding how to determine the "amount involved" in transactions, and to clarify that the amounts reported must be in dollars even if the amount was set or expensed in a different currency. The term amount involved would mean the dollar value of the transaction, or series of similar transactions, and would include:

- 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; and
- in the case of indebtedness, the largest aggregate principal 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.

Disclosure requirements

Proposed Item 404(a) would also provide the disclosure requirements for related person transactions. See Release No. 33-8655, Part V.A.2. The company would be required to describe the transaction, including:

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- the person's 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 dollar value of the amount involved in the transaction and of the related person's interest in the transaction.

As is the case today, the dollar value would be computed without regard to the amount of the profit or loss involved in the transaction. Because of the manner in which the value of the amount involved is calculated for indebtedness, disclosure with respect to indebtedness would include the largest aggregate amount of principal outstanding during the period for which disclosure is provided, as well as the amount of principal and interest paid during the period for which disclosure is provided, the aggregate amount of principal outstanding as of the latest practicable date, and the rate or amount of interest payable on the indebtedness.

The SEC proposes to eliminate a current instruction that, in the case of a related person transaction involving a purchase of assets by the company or sale of assets to the company, calls for specific disclosure of the cost of the assets if acquired within two years of the transaction. But the Commission cautioned that, if such information was material under the proposed standards of Item 404(a), because, for example, the recent purchase price to the related person was materially less than the sale price to the company, or the sale price to the related person was materially more than the recent purchase price to the company, disclosure of such prior purchase price could be required.

Currently, disclosure must be provided regarding amounts possibly owed to the company under Section 16(b) of the Exchange Act. The purpose of related person transaction disclosure differs from the purpose of Section 16(b). Accordingly, the rule proposals eliminate the Section 16(b)-related disclosure requirement. Disclosure of compensation to an executive officer or director would not be required if the compensation is reported pursuant to Item 402.

Exceptions

With regard to transactions involving indebtedness, the following items of indebtedness would be excluded from the calculation of the amount of indebtedness and need not be disclosed because they do not have the potential to impact the parties as the transactions for which disclosure is required: amounts due from the related person 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.

Also in the case of indebtedness, if the lender is a bank, thrift, 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 may consist of a statement that the loans to such persons were made in the ordinary course of business on substantially the same terms as those for comparable loans to persons not related to the bank and did not involve more than the normal risk of collectability.

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This proposed exception is based on a current instruction to Item 404(c), and has been modified to be more consistent with the prohibition of the Sarbanes-Oxley Act on personal loans to officers and directors.

Finally, a person who has a position or relationship with a firm, company, or other entity that engages in a transaction with the company will not be deemed to have an indirect material interest within the meaning of paragraph (a) of Item 404 if the interest arises:

- only: (i) from the person's position as a director of another company which 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
- 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.

Procedures for approving related-party transactions

The proposal would require a description of the company's policies and procedures for the review, approval or ratification of transactions with related persons that would be reportable under Item 404(a). See Release No. 33-8655, Part V.B. The description would include the material features of the policies and procedures that are necessary to understand them**.** While the material features of such policies and procedures would vary depending on the particular circumstances, examples of such features may include the types of transactions that are covered by such policies and procedures and the standards to be applied pursuant to them, as well as the directors' responsible for applying them and whether they are in writing. The proposal would also require the identification of any transactions required to be reported where the company's policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed.

Promoters

The SEC would require a company to provide disclosure regarding the identity of promoters and its transactions with those promoters if the company had a promoter at any time during the last five fiscal years. See Release No. 33-8655, Part V.C. The disclosure would be required in Securities Act registration statements on Form S-1 or Form SB-2, and Exchange Act Form 10 or Form 10-SB.

The proposed disclosure would include the names of the promoters and the nature and amount of anything of value they received from the company and the nature and amount of any consideration received by the company, as well as information on any assets acquired by the company from a promoter.

The proposed disclosure requirements are consistent with those currently required regarding promoters. However, this disclosure is not currently required if the company

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has been organized more than five years ago, even if the company otherwise had a promoter within the last five years.

The SEC staff's experience in reviewing registration statements, especially of smaller companies, suggests that the more appropriate five-year test would relate to the period of time during which the company had a promoter for which the disclosure should be provided, rather than the date of organization of the company.

The Commission is also proposing to require the same disclosure 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. The term group would have the same meaning as in Exchange Act Rule 13d-5(b)(1), which is any two or more persons that agree to act together for the purpose of acquiring, holding, voting, or disposing of equity securities of an issuer.

Small business issuers

Proposed Item 404 of Regulation S-B is substantially similar to proposed Item 404 of Regulation S-K, except for the following two matters. First, paragraph (b) relating to policies and procedures for reviewing related-party transactions is proposed not to be included in Regulation S-B. Second, Regulation S-B would provide for a disclosure threshold of the lesser of $120,000 or one percent of the average of the small business issuer's total assets for the last three completed fiscal years, to require disclosure for small business issuers that may have material related person transactions even though smaller than the absolute dollar amount of $120,000. See Release No. 33-8655, Part V.E.1.

Foreign private issuers

Currently a foreign private issuer will be deemed to comply with Item 404 of Regulation S-K if it provides the information required by Item 7.B. of Form 20-F. The proposals would retain this approach, but would require that if more detailed information is required to be disclosed by the issuer's home jurisdiction or a market in which its securities are listed or traded, that same information must also be disclosed pursuant to Item 404. See Release No. 33-8655, Part V.E.2.

Investment companies

With regard to investment companies, Items 7 and 22(b) of Schedule 14A would be revised to reflect the reorganization that has been proposed for operating companies. Under the proposals, information that is currently required to be provided by investment companies under Item 7 would instead be required by Item 22(b). See Release No. 33-8655, Part V.E.3.

The requirements of Item 7 that are currently applicable to investment companies regarding the nominating and audit committees, board meetings, the nominating process, and shareholder communications generally would be included in Item 22(b) by cross references to the appropriate paragraphs of proposed Item 407 of Regulation S-K. The substance of these requirements would not be altered. In addition, the proposed revisions to Item 22(b) would directly incorporate disclosures relating to the independence of

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members of nominating and audit committees that are similar to those contained in proposed Item 407(a) and currently contained in Item 7.

The SEC also proposes to raise from $60,000 to $120,000 the threshold for disclosure of interests, transactions, and relationships of each director or nominee for election as director who is not an interested person of an investment company within the meaning of Section 2(a)(19) of the Investment Company Act. This disclosure is required in investment company proxy and information statements and registration statements. The increase in the disclosure threshold would correspond to the proposal to increase the disclosure threshold for Item 404 from $60,000 to $120,000.

Corporate governance

The SEC proposes to consolidate the disclosure requirements regarding director independence and related corporate governance requirements under a single disclosure item and to update such requirements regarding director independence to reflect current listing standards and rules. See Release No. 33-8655, Part V.D.

Current rules provide for the disclosure of business relationships between directors and the company that may bear on their ability to exercise independent judgment in the performance of their duties. In addition, as directed by the Sarbanes-Oxley Act, the SEC ordered national securities exchanges to adopt listing standards requiring independent audit committees. Further, in 2003 and 2004, the SEC approved amendments to additional listing standards, including those of the New York Stock Exchange and Nasdaq that imposed added independence standards for boards of directors and their compensation and nominating committees.

Currently, each listed company determines whether its directors and committee members are independent based on definitions that it adopts which, at a minimum, must comply with the listing standards applicable to the company.

The SEC proposes to include a disclosure requirement identifying the independent directors of the company, and, in the case of disclosure in proxy or information statements, nominees for director, under the definition for determining board independence applicable to it. The proposals would also require disclosure of any members of the compensation, nominating and audit committee that the company had not identified as independent under the definition of independence for that board committee.

More specifically, listed companies would have to disclose those directors and director nominees that they identify as independent, and committee members not identified as independent, using a definition for independence that is in compliance with the applicable listing standards.

Companies that are not listed issuers would disclose those directors and director nominees that they identify as independent, and committee members not identified as independent, using the definition for independence of a national securities exchange or a national securities association specified by the company. The company would be required to apply the same definition consistently to all directors and also to use the independence standards of the same national securities exchange or national securities association for purposes of determining the independence of members of the compensation, nominating and audit committees.

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The proposals would require a company that has adopted definitions of independence for directors and committee members to disclose whether those definitions are posted on the company's website, or include the definitions as an appendix to the company's proxy materials at least once every three years.

Further, if the policies are not on the company's website, or included as an appendix to the company's proxy statement, the company would have to disclose in which of the prior fiscal years the policies were included in the company's proxy statement. In addition, the proposals would require, for each director or director nominee identified as independent, a description of any transactions, relationships or arrangements not disclosed pursuant to paragraph (a) of Item 404 that were considered by the board of directors of the company in determining that the applicable independence standards were met.

This independence disclosure would be required 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 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. In this regard, the SEC believes that the independence status of a director is material while the person is serving as director, and not just as a matter of reelection.

The proposals would also revise the current disclosure required regarding the audit committee and nominating committee to eliminate duplicative committee member independence disclosure and to update the required audit committee charter disclosure requirement for consistency with the more recently adopted nominating committee charter disclosure requirements. As a result, the audit committee charter would no longer have to be delivered to shareholders so long as it is posted on the company's website. The disclosure on audit committee financial experts would also be moved to Item 407, but with no substantive changes.

The SEC is proposing disclosure about compensation committees that is similar to what is currently required for audit and nominating committees. The company would be required to describe its processes and procedures for the determination of executive and director compensation, including the scope of authority of the compensation committee, the extent to which the committee may delegate its authority, and whether the committee's authority is set forth in a charter, and if so, the company's website address at which a current copy is available if it is so posted. If the charter is not so posted, it must be attached to the proxy statement once every three years. The company must also disclose any role of executive officers in determining the amount or form of executive and director compensation.

Similarly disclosed should be any role played by compensation consultants in determining or recommending the amount or form of executive and director compensation. The company should also identify such consultants, state whether they are engaged directly by the compensation committee, describe the nature and scope of their assignment and the material elements of their instructions, and also identify any executive officer the consultants contacted in carrying out their assignment.

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In addition, disclosure would be required regarding each member of the compensation committee that the company has identified as not independent. Further, the rule proposals would consolidate into this compensation committee disclosure requirement the disclosure currently required in Item 402 regarding compensation committee interlocks and insider participation in compensation decisions.

For companies other than registered investment companies, the rule proposals would eliminate an existing proxy disclosure requirement regarding directors that have resigned or declined to stand for re-election, which is no longer necessary since it has been superseded by a disclosure requirement in Form 8-K. For registered investment companies, which do not file Form 8-K, the requirement would be moved to Item 22(b) of Schedule 14A. Also, the rule proposals would combine various proxy disclosure requirements regarding board meetings and committees into one location

Beneficial Ownership Disclosure

The SEC would require footnote disclosure of the number of shares pledged as security by named executive officers, directors and director nominees. This would be effected by changes to Item 403(b) of Regulation S-K. See Release No. 33-8655, Part IV.

To the extent that shares beneficially owned are used as collateral, they may be subject to material risk or contingencies that do not apply to other shares. Since these circumstances have the potential to influence management's performance and decisions, the SEC believes that the existence of these securities pledges could be material to shareholders.

Because significant shareholders who are not members of management are in a different relationship with other shareholders and have different obligations to them, the proposals would not require disclosure of their pledges, other than pledges that may result in a change of control currently required to be disclosed.

The proposals also would require disclosure of beneficial ownership of directors' qualifying shares, which is currently not required, because the beneficial ownership disclosure should include a complete tally of the securities beneficially owned by directors.

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