SEC Adopts Executive Compensation and Related-Party Disclosure Reforms

A CCH Analysis by
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Introduction

The U.S. Securities and Exchange Commission has adopted a sweeping overhaul of its rules governing disclosure of executive and director compensation, related person transactions, director independence and other corporate governance matters. Adopted July 26, 2006, the reforms are intended to provide investors with a clearer and more complete picture of compensation paid to principal executive officers, principal financial officers, and the highest paid executive officers and directors.

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 has 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 SEC can help shareholders and board compensation committees assess the information themselves and reach their own conclusions.

Similarly, the SEC has 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 Reforms

Under this broad policy, the goal of the executive and director compensation disclosure regime is to provide investors with clearer, better organized and more complete disclosure regarding the mix, size and incentive components of executive and director compensation. This goal would be accomplished 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.

According to John White, Director of the Corporation Finance Division, the rule changes and guidance will significantly improve the quality and usefulness of the information that investors receive about executive compensation. For the first time, investors will be provided with one number for total annual compensation for each named executive officer. The clarity and comparability of this one number will be complemented by the

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principles-based narrative disclosures and by the requirement that these disclosures be made in plain English.

The SEC will require enhanced narrative disclosure, in the form of a Compensation Discussion and Analysis (CD&A) section, and narrative disclosure accompanying the tables, to explain the significant factors underlying the compensation decisions reflected in the tabular data. The rules 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 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 will 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 duties 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 the regime 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 new rules, including requirements to disclose a total amount of compensation and more detail regarding compensation policies, could alter existing policies in these areas.

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Compliance

For Forms 10-K and 10-KSB, compliance will be required for fiscal years ending on or after December 15, 2006. Similarly, for proxy and information statements covering companies other than registered investment companies, compliance will be required for any new proxy or information statements filed on or after December 15, 2006, that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

Executive and Director Compensation

The 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.

The revisions to the compensation disclosure rules attempt to provide investors with a clearer, more complete picture of compensation to principal executive and financial officers, the other highest paid executive officers, and directors.

The SEC has added the principal financial officer as a named executive officer subject to disclosure, a move applauded by commenters. The Commission 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 Sarbanes-Oxley certifications required with the company's periodic reports and has important responsibility for the fair presentation of the company's financial statements.

Compensation Discussion and Analysis

The CD&A will address the objectives and implementation of executive compensation programs, focusing on the most important factors underlying each company's compensation policies and decisions. Despite concerns expressed by a number of commenters, the CD&A will be filed and thus be a part of the disclosure subject to Sarbanes-Oxley certification by a company's principal executive officer and principal financial officer.

Further, a new furnished compensation committee report will require a statement of whether the compensation committee has reviewed and discussed the CD&A with management and, based on this review and discussion, recommended that it be included in the company's annual report on Form 10-K and proxy statement.

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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. 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.

The CD&A will also require enhanced narrative disclosure about option grants to executives. Companies will have to analyze and discuss, as appropriate, material information such as the reasons they select particular grant dates for awards or the methods they use to select the terms of awards, such as the exercise prices of stock options.

With regard to the timing of stock options, companies will be called upon in the guidance to answer questions such as whether they have any program or plan to time option grants to their executives in coordination with the release of inside information. They will also have to discuss how any program to time option grants to executives fits in the context of any program with regard to option grants to employees more generally. The role of the compensation committee in approving and administering such a program should be examined, and how the committee takes such information into account when determining whether and in what amount to make those grants. Similarly, there is the question of whether the compensation committee delegated any aspect of the actual administration of a program to any other persons.

The role of executive officers in the company's program should be discussed, as well as whether the company set the grant date of its stock options to new executives in coordination with the release of material inside information. Similarly, the guidance should address whether the company plans to time its release of inside information for the purpose of affecting the value of executive compensation.

Similar disclosure standards will apply if a company has a program of awarding options and setting the exercise price based on the stock's price on a date other than the actual grant date or if the company determines the exercise price of option grants by using formulas based on average prices (or lowest prices) of the company's stock in a period preceding, surrounding or following the grant date.

Compensation Tables

Following the CD&A, disclosure of executive compensation would fall into three broad categories: (1) compensation; (2) equity compensation; and (3) retirement and other post-employment benefits. The compensation tables have been reorganized and streamlined into three broad categories to clearly and logically provide a picture of total compensation and its elements for named executive officers.

The summary compensation table is the principal disclosure vehicle for executive compensation, showing compensation for each named executive officer over the last three years. Importantly, the table will include a column reporting the total compensation of the named executive officers.

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Director compensation for the last fiscal year will be required in a director compensation table, along with related narrative, which will be similar in format to the summary compensation table.

The summary compensation table will be accompanied by narrative disclosure and a grant of plan-based awards table that will help explain the compensation information presented in the table. The summary compensation table will also include, in addition to columns for salary and bonus, a dollar value for all equity-based awards, shown in separate columns for stock and stock options, measured at grant date fair value. The fair value will be computed pursuant to FASB Statement No. 123R, to provide a more complete picture of compensation and facilitate reporting total compensation.

Moreover, the table will include a column reporting the amount of compensation under non-equity incentive plans and a column reporting the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation, so that these amounts can be deducted from total compensation for purposes of determining the named executive officers.

Further, there will be a column showing the aggregate amount of all other compensation not reported in the other columns of the table, including perquisites. Perquisites will be included in the table unless the aggregate amount is less than $10,000. The SEC has provided interpretive guidance for determining what constitutes a perquisite. 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.

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.

The SEC had proposed that the accompanying narrative include disclosure for up to three non-executive employees whose total compensation was greater than that of any of the named executive officers. This provision was revised and reproposed for public comment. The new proposal would require that the accompanying narrative disclosure include the total compensation and job positions of each of a company's three most highly compensated employees, whether or not they were executive officers during the last completed fiscal year, whose compensation for the last completed fiscal year was greater than that of any of the named executive officers, except that employees having no responsibility for significant policy decisions within the company would be excluded when determining which employees are among the most highly compensated. In addition, the revised proposal would only apply to large accelerated filers.

The reproposal is evidently designed to address the main argument of commenters that the compensation of non-policymaking employees should not be subject to disclosure. But, according to Commissioner Paul Atkins, the devil is in the interpretation of policymaking. If, as the proposal in its current form provides, an employee becomes a

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policymaker through exercising strategic, technical, editorial, creative, managerial, or similar responsibilities, Atkins posits that few highly-compensated employees would not be policymakers. Almost every job has some of these attributes, he reasoned. Atkins also emphasized that tracking the compensation of employees who might potentially fit this bill across a large multi-national corporation with differing internal systems and managerial methods will be a costly undertaking. In his view, the reproposal goes beyond the purpose of executive compensation disclosure, which is to provide better information to stockholders for purposes of evaluating the actions of the board of directors in fulfilling its duties.

The required disclosure regarding outstanding equity interests will include outstanding equity awards at fiscal-year end table, which will show outstanding awards representing potential amounts that may be received in the future, including such information as the amount of securities underlying exercisable and unexercisable options, the exercise prices and the expiration dates for each outstanding option, and the option exercises and stock vested table, which will show amounts realized on equity compensation during the last fiscal year.

Retirement plan and post-employment disclosure will include the pension benefits table, which will require disclosure of the actuarial present value of each named executive officer's accumulated benefit under each pension plan, computed using the same assumptions and measurement period as used for financial reporting purposes under GAAP. The disclosure will also include the nonqualified deferred compensation table, which will require disclosure with respect to nonqualified deferred compensation plans of executive contributions, company contributions, withdrawals, all earnings for the year, and the year-end balance. Finally, there will have to be a narrative description of any arrangement that provides for payments or benefits at, following, or in connection with any termination of a named executive officer, a change in responsibilities, or a change in control of the company, including quantification of these potential payments and benefits assuming that the triggering event took place on the last business day of the company's last fiscal year and the price per share was the closing market price on that date.

Option Grants

The Commission has provided additional guidance regarding disclosure of company programs relating to the granting of options, including the timing of option grants in coordination with the release of inside information and the selection of exercise prices that differ from the underlying stock's price on the grant date. Required disclosure will include clear tabular presentations of option grants including: the grant date fair value; the FAS 123R grant date; the closing market price on the grant date if it is greater than the exercise price of the award; and the date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date. Further, if the exercise price of an option grant is not the grant date closing market price per share, the rules require a description of the methodology for determining the exercise price.

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Related-Party Disclosure

In addition to disclosure regarding executive compensation, a materially complete picture of financial relationships with a company involves disclosure regarding related party transactions. Thus, the SEC significantly amended its rules regarding related transactions.

The revision of Item 404 of Regulation S-K will provide investors with more complete disclosure of related person transactions, and new disclosure regarding a company's policies and procedures for the review, approval or ratification of relationships with related persons. The SEC has enhanced investor understanding of how corporate resources are used in related person transactions, and provided 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.

More specifically, the SEC has streamlined the related person transaction disclosure requirement and made it more principles-based. The changes to this disclosure requirement will include:

- Increasing the dollar threshold for transactions required to be disclosed from $60,000 to $120,000;
- Requiring disclosure of a company's policies and procedures for the review, approval or ratification of related person transactions;
- Eliminating the distinction between indebtedness and other types of related person transactions, and eliminating requirements for disclosure of specific types of director relationships; and
- Specifying exceptions for some categories of transactions that do not fall within the principle for disclosure under the related person transaction disclosure requirement.

The SEC emphasized that the current $60,000 threshold is not, and the new $120,000 threshold would not be, a bright-line materiality standard. The rule calls for, and will 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 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. 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.

The materiality test under Item 404 is ultimately based on the Supreme Court opinions in *TSC Industries v. Northway* (US Sup Ct 1976), 1976-77 CCH Dec. ¶95,615 and *Basic, Inc. v. Levinson* (US Sup Ct 1988), 1987-88 CCH Dec. ¶93,645. Under these opinions, materiality depends on the significance that a reasonable investor would place on the

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information. There must be a substantial likelihood that, under all the circumstances, the omitted or misrepresented fact would have assumed actual significance in a reasonable investor's investment decision. Stated differently, there must be a substantial likelihood that reasonable investors would have viewed disclosure of the fact omitted as having significantly altered the total mix of information.

Corporate Governance

With regard to corporate governance, the SEC adopted a new item under Regulation S-K to consolidate existing disclosure required in several places throughout the rules addressing director independence, board committee functions and other related governance matters. In most cases, there was no substantive change. The requirements are intended to enhance disclosures regarding independence required by corporate governance listing standards of national securities exchanges and associations.

The disclosure under this requirement will include:

- Disclosure of whether each director and director nominee is independent;
- A description, by specific category or type, of any transactions, relationships or arrangements not disclosed as a related person transaction that were considered by the board of directors when determining if applicable independence standards were satisfied;
- Disclosure of any audit, nominating and compensation committee members who are not independent; and
- Disclosure about the compensation committee's processes and procedures for the consideration of executive and director compensation

Form 8-K

The new rules modify the disclosure requirements in Form 8-K to capture some employment arrangements and material amendments thereto only for named executive officers. The rules will also consolidate all Form 8-K disclosure regarding employment arrangements under a single item.

Beneficial Ownership

The SEC will require disclosure of the number of shares pledged by management, and the inclusion of directors' qualifying shares in the total amount of securities owned. The Commission added to Item 403(b) a requirement for footnote disclosure of the number of shares pledged as security by named executive officers, directors and director nominees. To the extent that shares beneficially owned by named executive officers and directors are used as collateral, these shares may be subject to material risk or contingencies that do not apply to other shares beneficially owned by these persons.

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These circumstances have the potential to influence management's performance and decisions. For example, it has been argued that the extension of loans to the CEO of WorldCom, which were collateralized by the company's shares owned by the CEO, contributed to the company's financial demise.

As a result, 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 revisions would not require disclosure of their pledges pursuant to Item 403(a), other than pledges that may result in a change of control currently required to be disclosed.

The revisions would also specifically 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.

Investment Companies

The SEC has modified disclosure requirements for registered investment companies and business development companies. Specifically, the amendments will:

- Apply the executive compensation disclosure requirements for operating companies in their entirety to business development companies;
- Increase to $120,000 the current $60,000 threshold for disclosure of certain interests, transactions, and relationships of independent directors of registered investment companies, similar to the increase proposed for operating companies with respect to related party disclosure; and
- Reorganize the proxy rules applicable to investment companies to reflect organizational changes proposed for operating companies.

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