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Proxy Statements 2007: SEC Responds to Executive Compensation Disclosure Issues

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Those preparing 2007 proxy statements received welcome guidance from the Securities and Exchange Commission (SEC) on January 24, 2007, when the SEC updated its interpretations relating to Item 402 of Regulation S-K. This action follows the SEC's recent regulatory overhaul of its executive compensation disclosure requirements.[1]

Highlights from the SEC update appear below, along with a few practice tips from our experience to date with the SEC's new executive compensation disclosure rules.

1. Grant Programs, Plans or Practices (All Equity Awards) – The detailed disclosure required in the Compensation Discussion and Analysis ("CD&A") for option grant programs, plans and practices, such as the timing for awards, applies to all equity awards – *e.g.*, restricted stock awards.

> Practice Tip: *Consider adopting a grant-making policy that minimizes the risk of second-guessing and extra-disclosure. For example, limit grants to an open trading window period.*

2. Grant Programs, Plans or Practices (Other Years) – The disclosure in the CD&A relating to grant programs, plans or practices generally is limited to the fiscal year being disclosed in the proxy statement, but may require disclosure for other fiscal years depending on the facts-and-circumstances relevant to the year being disclosed. See Instruction 2 to the CD&A which points out that analysis should cover actions regarding executive compensation that were taken after the last fiscal year end, and which adds that in some situations it may be necessary to discuss prior years in order to give context to the disclosure provided.

3. Stock Grants in Lieu of Salary or Bonus – If a company permits executives to elect to receive stock awards in lieu of salary or cash bonuses, the Summary Compensation Table should report the compensation under the columns for salary and bonuses (although the column for stock awards should report any additional compensation that results from the executive's election to receive a stock award).

> Example: *Suppose an executive elects to receive $120 of restricted stock in lieu of $100 of salary. The Summary Compensation Table would report salary of $100 and a stock award of $20 (with the $20 being reported pro rata between company fiscal years based on its FAS 123R expense).*

4. Performance Goals – The nondisclosure of performance measures and targets is subject to the standards for confidential treatment that have developed under the Freedom of Information Act (FOIA). The SEC's telephone interpretations refer to three D.C. federal circuit decisions for the applicable standard, which is basically one of "substantial harm to the competitive position of the person from whom the disclosure was obtained."[2]

Companies should not be submitting confidential treatment requests to the SEC, but instead must apply the FOIA standard to themselves (and be ready to defend their position if the SEC raises a question).

> Practice Tip: *Beware of under-disclosing performance targets. The SEC has informally stated that budgeted financial goals are presumptively not confidential for CD&A discussion purposes, especially if they relate to closed periods. The SEC has further warned – vigorously – that it will closely examine nondisclosures on the basis of confidentiality.*

5. Post-year-end Awards – As we have been advising, stock awards are reported in the Summary Compensation Table for the fiscal year in which the grant date occurs, even if the grant relates to services in a prior year. However, if a grant occurs after year end (*e.g.*, Jan. 2007) for services performed during the year being disclosed (*e.g.*, 2006), the CD&A for that year (*e.g.*, 2006) should discuss the grant.

6. New NEOs in Later Years – Good news, if a person becomes a named executive officer (NEO) in a year after 2006, the compensation to be disclosed will not apply to years (*e.g.*, 2006) before the person became an NEO.

Practice Tip: *Because of the detailed discussion required in future proxy statements, we generally suggest that companies track executive compensation data for all executives who are SEC Section 16 reporting persons (i.e., those who file SEC Forms 3, 4, and 5). Capturing this data on an annual basis is likely to avoid future fire drills when assembling the tables and preparing the discussion relating to NEO compensation.*

7. Perquisites – If the $10,000 threshold is exceeded, the proxy statement's itemization of perquisites must include even those with no incremental cost. However, disclosure is not required for perquisites for which an executive actually fully reimbursed the company for its total cost.

Practice Tip: *Many companies are eliminating as many perquisites as possible, sometimes through salary adjustments. In the future, this should help to avoid the need for attention to what are generally immaterial items of compensation. If salaries are increased to offset eliminated perquisites, this will require explanation in the CD&A.*

8. Employee Stock Purchase Plans – No compensation disclosure is required for discount sales prices that are provided through a broad-based plan employee stock purchase plan (aka ESPP), such as a compliant Internal Revenue Code Section 423 plan.

9. Dollar-denominated Stock Awards – The table titled "Grants of Plan-based Awards" should disclose dollar-denominated stock awards (*e.g.*, $100K of stock based on FMV on future date if earned) in dollars as opposed to shares, in which case the column heading should change accordingly (to reference dollars), with a footnote or narrative to explain.

10. Dividends on Equity Awards – If an award provides an executive with the absolute right to receive cash dividends on the shares underlying the award, then the Summary Compensation Table should include the full fair market value of the underlying shares should determine the grant date value of the award. In these cases, disclosure is not required for future dividend accruals on the shares subject to the stock award (because the market price of a share at the time of the award is presumed to take into account the right of a shareholder to collect the future dividend stream).

On the other hand, the following disclosure implications would result if a company is not obligated to pay dividends, but rather has the discretion to accrue or to pay dividends on the shares subject to an award:

- Must discount the grant date value of the underlying shares – with the discount being necessary to strip out the value that the market place attributes to the right of a shareholder to receive the future dividend stream (because the award holder is not receiving that right, due to the discretion the company is retaining); and

- Must report award-based dividend payments in Column (i) (All Other Compensation) of the Summary Compensation Table, as other compensation, because of the discretionary nature of the payment.

11. Stock Option Net Exercise – The "Option Exercises and Stock Vested" Table should disclose the total number of shares that are subject to an exercised option, with a footnote or narrative to disclose the net number of shares issued if the company withholds shares to cover the exercise price or taxes payable by the executive.

12. Director Compensation – Disclosure is required for anyone serving as a director for any part of a year, even if the person resigned or is not standing for reelection. Separately, the proxy statement must disclose all compensation paid to each director for any services, including compensation for services outside the scope of the director's service on the Board (*e.g.*, compensation for services as consultant).

13. Corporate Mergers – The SEC's updated interpretations permit companies to disregard compensation paid by target before a corporate merger date, except in "situations involving an amalgamation or combination of companies." This exception appears limited to transactions structured or functioning as mergers of equals or their rough equivalents.

14. Change of Fiscal Year – Subtle and exacting rules need to be consulted. They generally require that companies determine their NEO group through a one-year look back from the fiscal year end being reported, with disclosure required only for compensation paid during the stub period.

15. Deferred Compensation Earnings – The Summary Compensation Table does not require disclosure in column (h) for above-market or preferential returns if an executive's rate of return on deferred compensation is based on market portfolio, as opposed to a guaranteed above-market interest rate. If an NEO accrues benefits under more than one non-qualified deferred plan with some being positive and others being negative, the net accrual is reportable in the summary compensation table (but note the "no negative numbers" rule).

16. Pension Plan Benefits – A company may not use an NEO's personal pension data for proxy statement disclosure of pension benefits, and must instead follow generally accepted accounting principles when calculating the actuarial present value of an NEO's accrued benefits.

17. Reimbursement of Legal Expenses re Litigation – The SEC does not require disclosure under Item 402 of the reimbursement of legal expenses with respect to a lawsuit in which an NEO is a named defendant in his or her capacity as a corporate officer.

CONCLUSION

The SEC's new executive compensation disclosure rules are doubling and tripling the length of past disclosures, with a key determinant being the tables that assemble 2006 compensation data. We are finding that many companies have been getting out in front of the significant compliance task by preparing initial drafts of the compensation tables as early as practicable as they head into proxy season, as well as framing the Compensation Discussion & Analysis first by reference to past disclosures and then by identifying specific disclosures required by SEC's new rules.

At the end of last year, BNA published our suggested approach for writing a CD&A. The article is titled "*Getting Started with Writing the Compensation Discussion & Analysis*" (Poerio, BNA Pension and Benefits Reporter, Nov. 28, 2006). Please contact any of our attorneys listed below if you would like to receive a copy of our CD&A article, our client alerts summarizing the SEC rule changes, an Excel spreadsheet with the required tables, and/or assistance in framing a CD&A.

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[1] *See* our client alert summarizing the SEC's revised executive compensation and related party disclosure rules (August 2006). Available at http://www.paulhastings.com/Backup/Client_Alerts/35344.PDF?wt.mc_ID=35344.pdf.

[2] *National Parks and Conservation Assoc. v. Morton*, 498 F. 2d 765, at 770 (D.C. Cir. 1974). The other two cases cited in the SEC's FAQs are *National Parks and Conservation Assoc. v. Kleppe*, 547 F. 2d 673 (D.C. Cir. 1976) and *Critical Mass Energy Project v. NRC*, 931 F. 2d 939 (D.C. Cir. 1991), vacated & reh'g en banc granted 942 F. 2d 799 (D.C. Cir. 1991), grant of summary judgment to agency aff'd en banc, 975 F. 2nd 871 (D.C. Cir. 1992).

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