

## **SEC PROPOSES SIGNIFICANT CHANGES TO EXECUTIVE COMPENSATION AND RELATED DISCLOSURE**

**February 16, 2006**

The Securities and Exchange Commission (“SEC”) recently published for comment amendments to the disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters and security ownership of officers and directors.<sup>1</sup> These amendments would apply to disclosure in proxy and information statements, periodic reports, current reports and registration statements. The proposed amendments are intended to provide investors with a clearer and more complete picture of executive and director compensation and to provide better information about key financial relationships among companies and their executive officers, directors and significant shareholders and their respective immediate family members. These rules are expected to be adopted following a 60-day comment period. Once adopted, it is anticipated that the final rules will be effective in time for the 2007 proxy season.

### **Executive and Director Compensation Disclosure**

The SEC is proposing revisions to the current executive compensation disclosure requirements that would require more extensive tabular presentations supplemented by improved narrative disclosure. The SEC intends that the new approach will promote more complete quantitative disclosures through improved tables, continue to provide the ability to make comparisons using tables and require material qualitative disclosures regarding the manner and context in which compensation is awarded and earned.

### Compensation Discussion and Analysis

Under the proposals, compensation disclosure would begin with a narrative overview, entitled Compensation Discussion and Analysis (“CD&A”), which would provide a discussion and analysis of the material factors underlying compensation policies and decisions reflected in the data presented in the compensation tables. The CD&A would explain the material elements of a company’s compensation for named executive officers by discussing such items as the company’s compensation objectives, identifying each element of compensation (and the methods for determining amounts payable under each element) and other related topics.

The scope of the CD&A would be comprehensive, including both in-service and post-termination compensation arrangements and would, where appropriate, be required to discuss

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<sup>1</sup> Executive Compensation and Related Party Disclosure, Securities Act Release No. 33-8655 (January 27, 2006) (available at <http://www.sec.gov/rules/proposed/33-8655.pdf>).

(among other things) the effect of prior compensation on decisions regarding various elements of compensation, the use of benchmarking and the role of executive officers in the compensation-decision process. Boilerplate disclosure would not suffice. The CD&A section would replace the Board Compensation Committee Report on Executive Compensation and Performance Graph currently required by SEC rules. The CD&A would be considered “filed” with the SEC and thus subject to the liability provisions of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and covered by the CEO and CFO certifications required under the Sarbanes-Oxley Act of 2002.

## Compensation Tables

Following the CD&A, the compensation tables and related narrative disclosure would be divided into three broad categories: (a) the Summary Compensation Table and related disclosure, (b) holdings of equity-based interests that relate to compensation or are potential sources of future compensation and (c) retirement and other post-employment compensation.

### Summary Compensation Table and Related Disclosure

The first broad category would provide disclosure of compensation in the last three fiscal years in the Summary Compensation Table, accompanied by two supplemental tables and a narrative discussion. The Summary Compensation Table currently required under SEC rules would continue to serve as the principle executive compensation disclosure vehicle, requiring disclosure of the named executive officers’ compensation for each of the last three years, but it would be modified to provide greater clarity. For example, the table would include a new figure representing total compensation, which would aggregate the total dollar value of each form of compensation quantified in the remaining columns of the table. In addition, stock awards and option awards would be disclosed and valued at their grant date fair value as determined pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004). Finally, the current “All Other Compensation” and “Other Annual Compensation” columns would be combined into one “All Other Compensation” column, which would include all compensation not reportable under the other columns, including, but not limited to, earnings on deferred compensation, company contributions to defined contribution plans, increases in pension value, expanded perquisite disclosure and amounts paid or accrued pursuant to a severance or change in control arrangement. With respect to perquisite disclosure, the threshold would be reduced from \$50,000 to \$10,000, and the SEC is providing interpretive guidance regarding benefits that should be categorized as perquisites (as discussed in more detail below).

The Grants of Performance-Based Awards Table, the first supplemental table to the Summary Compensation 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). This table would disclose the terms of grants made during the current year, including estimated future payouts, with separate disclosure for each grant. The table would replace the Long-Term Incentive Plan Awards Table currently required by SEC rules.

The second table supplementing the Summary Compensation Table, the Grants of All Other Equity Awards 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. The table would include the terms of each grant (including repricings) made during the year, including the number of securities underlying the award, the exercise or base price and vesting and expiration dates. The table would replace the Option/SAR Grants in Last Fiscal Year Table currently required by SEC rules.

Finally, companies would be required to provide a narrative description of any additional material factors necessary to an understanding of the information disclosed in the Summary Compensation Table and its supplemental tables. Unlike the CD&A, which would focus on broad topics regarding the objectives and implementation of executive compensation policies, this disclosure would be designed to put the quantitative tabular disclosures in context, for instance, by describing the material terms of employment agreements, option repricings, other material modifications of stock awards, performance factors applicable to performance-based awards and other matters. This narrative section would also disclose the job description and total compensation for the most recent fiscal year of up to three employees who were not executive officers during the last fiscal year but whose total compensation for such year was greater than that of any of the named executive officers.

#### Exercises and Holdings of Previously Awarded Equity

The next section would provide investors with an understanding of outstanding equity compensation that remained unexercised or unvested at fiscal year-end. Specifically, the Outstanding Equity Awards at Fiscal Year-End Table would disclose information regarding outstanding grants of awards under, for example, stock option or stock appreciation rights plans, restricted stock plans, incentive plans and similar plans, along with the market-based values of the awards granted under such plans as of the company's most recent fiscal-year end. Currently, this disclosure is provided only for holdings of outstanding stock options and stock appreciation rights in the Aggregated Option/SAR Exercises in Last Fiscal Year and Fiscal Year-End Option/SAR Values Table under existing SEC rules.

Next, the Option Exercises and Stock Vesting Table would present the amounts received upon exercise of options or similar instruments or the vesting of stock or similar instruments during the most recent fiscal year. This information is currently only required for options and stock appreciation rights.

#### Post-Employment Compensation

The final section of executive compensation disclosure would include tables regarding defined benefit pension plans and non-qualified defined contribution plans, as well as enhanced disclosure regarding compensation arrangements triggered upon a change in control. These disclosures would be designed to address shareholder and SEC concerns that the sizes of many executives' retirement and change of control pay packages are largely undetected.

The Retirement Plan Potential Annual Payments and Benefits Table would disclose estimated annual retirement payments under defined benefit plans for each named executive officer, followed by narrative disclosure. Disclosure would be required for each plan in which a named executive officer participates that provides for the payment of specified retirement benefits, or benefits that will be paid primarily following retirement. The table would be followed by a narrative description of material factors necessary to an understanding of each plan disclosed in the table. This disclosure would significantly expand the Pension Plan Table and related disclosure currently required by SEC rules.

Next, the Nonqualified Defined Contribution and Other Deferred Compensation Plans Table would disclose employer and employee contributions, earnings and balances under nonqualified defined contribution and other deferred compensation plans. Currently, only earned compensation and above-market earnings on nonqualified deferred compensation are disclosed (in the Summary Compensation Table), but no tabular disclosure is required regarding deferred compensation plans. This new table would also be followed by a narrative description of the material factors necessary to an understanding of the disclosure in the table.

Finally, the new rules would require narrative disclosure of specific aspects (including estimated payouts) related to any written or unwritten arrangement that provides for payments at, following, or in connection with the resignation, severance, retirement or other termination (including constructive termination) of a named executive officer, a change in his or her responsibilities or a change in control of the company. Qualitative disclosure would be required even where uncertainties exist as to amounts payable under the arrangements.

#### Officers Covered

The compensation tables and narrative disclosure described above would apply to the principal executive officer, the principal financial officer and the three other most highly compensated executive officers whose total compensation for the last fiscal year exceeded \$100,000. In addition, as is currently the case, disclosure would be required for 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.

#### Director Compensation

The rules propose a new Director Compensation Table, which would resemble the proposed Summary Compensation Table, but would present information only with respect to the company's last completed fiscal year. For each director, the company would disclose the total compensation, fees earned or paid in cash, stock awards, option awards, non-stock incentive plan compensation and all other compensation (such as consulting fees, charitable awards, etc.). In addition to the specified tabular disclosure, companies would disclose for each director, by footnote to the appropriate column, the outstanding equity awards at fiscal year end as would be required if the Outstanding Equity Awards at Fiscal Year-End Table included directors. Instructions to the Summary Compensation Table would apply to analogous matters in the

Director Compensation Table. Following the table, narrative disclosure would describe any material factors necessary to an understanding of the table, such as a breakdown of types of fees.

### **Proposed Revisions to Form 8-K and the Periodic Report Exhibit Requirement**

The SEC noted in its release that the adoption of significant revisions to Form 8-K has resulted in voluminous executive compensation disclosures under Item 1.01 of Form 8-K, not all of which are necessarily material. As a result, the SEC is now proposing to amend Item 1.01 of Form 8-K to eliminate employment compensation arrangements and to cover such arrangements under Item 5.02.<sup>2</sup> Specifically, Item 5.02 would be revised to include:

- Information regarding retirement, resignation or termination of all persons falling within the definition of “named executive officers” for the company’s previous fiscal year, whether or not included in the list currently specified in Item 5.02;
- 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 modification) of an award to a covered person under any plan, contract or arrangement in connection with any such event; and
- A brief description of any material new or modified compensatory plan, contract or arrangement, or new or modified grant or award under a plan, applicable to the principal executive officer, the principal financial officer or any named executive officer for the company’s previous fiscal year, whether or not the event is in connection with an Item 5.02 triggering event. Grants would not be required to disclosed if they were consistent with the terms of previously disclosed arrangements and they were disclosed the next time required under Item 402 of Regulation S-K.

The SEC has also proposed to extend the safe harbors under Section 10(b), Rule 10b-5 and Form S-3 to cover this new disclosure.

### **Beneficial Ownership Disclosure**

The SEC has proposed to amend Item 403(b) of Regulation S-K to add a requirement for footnote disclosure in the beneficial ownership table of shares pledged as security by named executive officers, directors and director nominees. The table would also specifically require disclosure of beneficial ownership of directors’ qualifying shares.

### **Certain Relationships and Related Transactions Disclosure**

As discussed further below, the proposed amendments would revise the related party transaction disclosure regime as follows:

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<sup>2</sup> Similarly, information regarding terminations of material definitive agreements currently disclosed under Form 8-K Item 1.02 would also be covered under Item 5.02.

- Regulation S-K Item 404(a) would contain a general disclosure requirement for related person transactions;
- Item 404(b) would require disclosure regarding the company's policies and procedures for the review, approval or ratification of related person transactions;
- Item 404(c) would require disclosure regarding promoters of a company; and
- New Item 407 would consolidate current corporate governance disclosure requirements.

### Transactions with Related Persons

Under proposed Item 404(a), a company would generally be required to provide disclosure regarding any transaction since the beginning of the company's last fiscal year, or any currently proposed transaction, in which the company was or is to be a participant, in which the amount involved exceeds \$120,000 (rather than the current \$60,000) and in which any related person had, or will have, a direct or indirect material interest. The term "transaction" would be broadly interpreted and would include indebtedness of related persons, currently disclosed separately under Item 404(c). "Related persons" would include any person who was in any of the following categories at any time during the disclosure period: directors and executive officers of the registrant, nominees for director (when the disclosure appears in a proxy or information statement involving the election of directors), five percent shareholders and immediate family members of any of these persons. Required disclosure regarding a related person transaction would include the person's relationship to the company, the person's interest in the transaction, the dollar value of the amount involved in the transaction and of the related person's interest in the transaction and any other information regarding the transaction or the related person in the context of the transaction that is material to investors.

### Procedures for Approval of Related Person Transactions

Item 404(b) 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). The description would include the material features of these policies and procedures that are necessary to understand them. Also included would be identification of any transactions reported under Item 404(a) for which the company's policies did not require review or as to which such policies and procedures were not followed.

### Promoters

Proposed Item 404(c) would require a company to provide disclosure in Forms S-1, SB-2, 10 or 10-SB regarding the identity of promoters and transactions with those promoters if the company had a promoter at any time during the last five fiscal years. The disclosure would include the names of the promoters, the nature and amount of anything of value received by each promoter from the company, the nature and amount of any consideration received by the company from a promoter and additional information regarding any assets acquired by the company from a promoter.

## Corporate Governance Disclosure

New Regulation S-K Item 407 would consolidate the current disclosure requirements regarding director independence and related corporate governance disclosure requirements under a single disclosure item and update these disclosure requirements to include those of the principal securities markets' listing standards. Specifically, Item 407 would require identification of the independent directors of the company (and nominees for directors in a proxy or information statement) under the applicable definition of board independence. The proposals would also require identification of any members of the compensation, nominating or audit committee that the company had not identified as independent. Additionally, Item 407 would include, among other items:

- Disclosure regarding the availability of the company's definition of director independence on the company's Web site, as an appendix to the proxy materials or in the proxy materials.
- A description of any transactions, relationships or arrangements not disclosed pursuant to Item 404(a) that were considered by the company in determining the independence of a director.
- Disclosure regarding compensation committees that is similar to that currently required for nominating committees under Item 7(d) of Schedule 14A, including, but not limited to, the scope of authority of the compensation committee, information regarding delegation of compensation committee authority and any role of executive officers and consultants in determining or recommending director and executive compensation.
- Information regarding compensation committee interlocks and insider participation in compensation decisions that is currently required to be disclosed under Item 402(j).

Finally, for all issuers other than investment companies, the proposals would eliminate the current disclosure requirement regarding directors that have resigned or declined to stand for re-election, since that information is now required to be disclosed on Form 8-K.

### **Small Business Issuers**

Under the proposals, disclosure requirements for small business issuers would be more limited than those for other issuers. Specifically, for executive and director compensation disclosure, small business issuers would be required to provide, along with the related narrative disclosure, the Summary Compensation Table (for the last two fiscal years only), the Outstanding Awards at Fiscal Year-End Table and the Director Compensation Table. In addition, information would be required only for the principal executive officer and the two most highly compensated officers other than the principal executive officer. Small business issuers would not be required to provide a CD&A.

For the related person transaction and corporate governance disclosure, the requirements for small business issuers would be substantially similar, except that the disclosure regarding policies and procedures for reviewing related party transactions required by proposed Item

404(b) would not be required, nor would the information regarding compensation committee interlocks and insider participation in compensation decisions. In addition, the disclosure threshold for related person transactions would be 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.

### **Registered Investment Companies**

As proposed, information currently required to be provided by registered investment companies under Schedule 14A Item 7 would instead be required by Item 22(b). In addition, the SEC is proposing to raise from \$60,000 to \$120,000 the threshold for disclosure of certain interests, transactions and relationships of each director or nominee for director who would not be considered an "interested person" of an investment company under Section 2(a)(19) of the Investment Company Act.

### **Plain English Disclosure**

As proposed, most of the disclosure required by Items 402, 403, 404 and 407 of Regulation S-K would be required to be provided in plain English. This requirement would apply when information responding to these items is to be included (whether directly or through incorporation by reference) in reports required to be filed under Sections 13(a) or 15(d) of the Exchange Act.

### **Effective Dates and Transition Rules**

Following their adoption and publication in the Federal Register, the proposed new rules and amendments would become effective:

- For Forms 10-K and 10-KSB, for fiscal years ending 60 days or more after publication;
- For Form 8-K, for triggering events that occur 60 days or more after publication;
- For proxy statements that are filed 90 days or more after publication; and
- For registration statements that become effective 120 days or more after publication.

Companies would not be required to restate compensation or related person transaction disclosure for previous fiscal years in which the new rules did not apply. This would result in phased-in implementation of certain items that require multi-year disclosure, such as the Summary Compensation Table.

### **What to Do Now**

Because these rule proposals have not yet been adopted, they are not required to be implemented in proxy statements for annual meetings in 2006. However, certain aspects of the proposals may offer companies guidance with respect to this year's disclosures. In addition, companies should consider taking steps to prepare for the rule changes once they become

effective since adoption of the final rules will require significant revisions to many companies' proxy materials and the processes involved in preparing them.

### Improve Perquisite Disclosure

The SEC proposing release includes interpretive guidance regarding factors to be considered in determining whether an item is a perquisite or other personal benefit. According to the SEC, an item would be excluded as a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties. Otherwise, the item is treated as a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees. Applying those guidelines, the SEC stated that examples of items requiring disclosure as perquisites include, but are not limited to, 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), 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 all employees. This guidance represents the SEC's current views and is thus not dependent upon the final adoption of the proposals.

### Consider Voluntarily Providing Supplemental Tables and/or Additional Narrative Disclosure Similar to the Type Required by the Proposed Rules

Companies may not replace the currently required tables with the proposed new tables, but they may add supplemental tables or supplemental columns to existing tables in this year's proxy statement. In addition, narrative disclosure may aid in disclosing compensation that does not fit squarely into the currently required tables.

### Consider Future Disclosure When Making Current Decisions

Although these proposals are subject to change before they are adopted in final form, it appears that current proxy disclosure regarding executive and director compensation will in any event be expanded. Thus, it is important for boards and compensation committees to consider how their current compensation decisions will be disclosed in future proxy statements. In addition, these proposals provide an opportunity for companies to review their current compensation plans and policies since the proposed CD&A will require increased disclosure regarding the company's compensation objectives.

### **Contact Information**

The following Womble Carlyle Corporate and Securities attorneys are available to assist you in addressing any questions that you may have regarding the proposed rules. Please contact the attorney with whom you usually work or any one of the following attorneys if you have any questions.

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