

## Final Executive Compensation Rules: Preliminary Memorandum - Key Changes to the Proposal

New York  
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On August 11, the SEC published its release (the “Release”) adopting substantially as proposed final rules for disclosure by U.S. companies of executive and director compensation, related person transactions and certain governance matters.<sup>1</sup> The rules reflect a thorough reworking of compensation disclosure – last overhauled in 1992 – and an effort to capture all forms of compensation in better-organized presentations that allow for greater comparability. The new disclosures must also be in plain English.

We expect that the rules, including the new Compensation Discussion and Analysis (or CD&A), will result in significant changes to a company’s disclosure controls and procedures. The new rules may also cause the Compensation Committee and the Board to adjust their approach to compensation and related person transactions.

The final rules are effective for reports on Form 10-K for fiscal years ending on or after December 15, 2006 (the “transition date”) and for proxy statements and registration statements (and amendments) under the Securities Act of 1933 (other than for investment companies) including disclosure for fiscal years ending on or after the transition date and filed on or after that date. The amendments to Form 8-K are effective for triggering events that occur 60 days or more after the Release is published in the Federal Register.<sup>2</sup> Companies need not, however, “restate” compensation or related person transaction disclosure for prior fiscal years. For example, in the first year of compliance, the Summary Compensation Table must present only the most recent fiscal year.<sup>3</sup>

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<sup>1</sup> SEC Rel. No. 33-8732; 34-54302; IC-27444 (Aug. 11, 2006), which is available at <http://sec.gov/rules/final/2006/33-8732.pdf>. The rules were proposed in SEC Rel. No. 33-8655; 34-53185; IC-27218 (Jan. 17, 2006), which is available at <http://sec.gov/rules/proposed/33-8655.pdf>.

<sup>2</sup> The new rules do not generally affect foreign private issuers, although the SEC did make certain limited amendments to its disclosure rules for those issuers, but they do affect disclosures by registered investment companies. The discussion that follows does not address these changes.

<sup>3</sup> Release at 196-197.

## Clear and Comprehensive Disclosure

Following closely the SEC's January 2006 proposal, the rules reflect the following key objectives:

- ***Greater context for quantitative presentations.*** The rules require a “principles-based” CD&A that effectively supplants the former Compensation Committee report. CD&A must describe the company’s objectives for its most highly compensated executive officers, its compensation program and how it relates to those objectives and its decisions about specific elements of compensation. The emphasis on narrative context is also evident in requirements that tabular presentations be accompanied by descriptions of material factors necessary to understand the quantitative data.
- ***More comprehensive and focused quantitative presentations.*** The rules require a more comprehensive Summary Compensation Table that presents all compensation earned or paid in the relevant fiscal year, discloses dollar values for all compensation, including all equity-based compensation, and provides a single figure for total compensation. While retaining a highly formatted tabular approach to foster comparability, the new rules require a more focused set of tables that cover not only total compensation, but also equity-related and incentive compensation, unexercised or unvested equity-related awards and retirement and deferred compensation benefits.
- ***Enhanced disclosure of retirement, deferred compensation and post-termination benefits.*** The rules will significantly increase and improve disclosure in these areas. The rules will for the first time require comprehensive disclosure, including quantitative disclosure, about deferred compensation and retirement, termination and change-in-control benefits.
- ***Greater attention to perquisites disclosure.*** The SEC and the staff have indicated concern regarding compliance with disclosure requirements for perquisites. The Release supplements the proposal and together they provide the first SEC guidance about perquisites in over 20 years. The guidance and the rule changes will result in more complete disclosure of perquisites.
- ***Streamlined current reporting on Form 8-K.*** The rules narrow current reporting requirements by uncoupling the materiality determination for Form 8-K compensation disclosure from the filing requirements of Item 601(b)(10) of Regulation S-K.

## Key Changes to the Proposal

The final rules contain a number of changes from the proposal, including the following:

- ***New disclosures reflecting options timing scandals.*** The rules include changes to both the equity-related compensation tables and CD&A that clearly result from the continuing ferment about options timing. The changes in some cases extend to other equity-related grants.
  - The rules require the use of the closing market price and the date on which the relevant corporate body took action as benchmarks for exercise price and grant date timing disclosure, even where a plan requires use of other measures. A company will need to make both tabular disclosure of any differences in exercise price or grant date from these benchmarks and will need to describe the reasons for the differences.
  - Companies must disclose, including in CD&A, programs, plans, practices and compensation decisions that relate to grant actions as they relate to the release (or withholding) of material non-public information. The requirements appear sufficiently broad to encompass programs, plans, practices and decisions designed to avoid pricing during periods when the company possesses such information.
- ***Disclosure about highly paid non-executive officers.*** The SEC did not adopt the proposed extension of compensation disclosure to up to three non-executive officers with compensation higher than that of a named executive officer. Rather, the SEC requests further comment on this requirement as refined to extend only to persons exerting significant policy influence at the parent, a significant subsidiary or principal business unit, division or function. The SEC suggests that this could consist of “the exercise of strategic, technical, editorial, creative, managerial or similar responsibilities.”<sup>4</sup> The SEC clarified that this formulation would not pick up investment professionals such as traders or portfolio managers simply as a result of performing the duties associated with those positions. The SEC also requests comment on whether the requirement should extend only to large accelerated filers (generally, companies with more than \$700 million of public float). The SEC’s request is likely to attract further extensive comment.
- ***New Compensation Committee report and relationship with CD&A.*** As proposed, CD&A will be “filed” with the SEC and subject to officer certification. Certifying

<sup>4</sup>

Release at 92.

officers may “look to” a new Compensation Committee report that will address the Committee’s review of the CD&A with management and its recommendation to include the CD&A in the company’s SEC filings. Like the comparable Audit Committee report, the Compensation Committee report will be “furnished” to the SEC.

- ***Additional guidance about scope and content of CD&A.***
  - Matters within the scope of CD&A have been expanded to include the role of the Compensation Committee and executive officers in any company program, plan or practice of option timing, the company’s policies for claw-backs of compensation upon restatement or adjustment of the relevant performance metrics and its basis for selecting particular triggering events for change-in-control payments, including single triggers. Because CD&A is principles-based and the disclosure examples are non-exclusive, it may also be appropriate to disclose other compensation policies (e.g., limitations on severance and change-in-control payments) in CD&A if they inform the structure of a company’s executive compensation program.
  - While the CD&A is focused upon the compensation of, and actions taken during, the fiscal year for which the report is being filed, it must also address actions taken after fiscal year-end, at least to the extent those actions could “affect a fair understanding” of the executive’s compensation for the last fiscal year. The Release also notes that discussion of prior periods may be appropriate in some cases.
  - An instruction to CD&A clarifies that performance targets based on non-GAAP financial measures are not subject to the general rules for use of those measures, but the company must disclose how the measures are derived from the audited financial statements.
  - Where performance targets are not disclosed for competitive reasons – a standard the SEC staff will interpret as being the same as that applied under the SEC’s confidential treatment rules – a company must provide additional disclosure about how difficult it will be for the executive or how likely it will be for the company to achieve the undisclosed target levels or other factors.
- ***Changes to proposed disclosures about retirement, deferred compensation and post-termination benefits.***
  - There are three significant changes in disclosure regarding retirement plan benefits and deferred compensation in the Summary Compensation Table. First, as under the existing rules, only above-market earnings on deferred compensation will be

included in the Summary Compensation Table, although all earnings will be disclosed in the Nonqualified Deferred Compensation Table. Second, such above-market earnings and increases in the actuarial present value of retirement plan benefits will be disclosed in a separate column in the Summary Compensation Table, rather than included in the All Other Compensation column. Third, the calculation of compensation for purposes of determining the highest paid executive officers will be based on total compensation, except that it will exclude earnings on deferred compensation and increases in the actuarial value of retirement benefits.

- The Pension Benefits Table is substantially modified and simplified. Notably, disclosure is effectively limited to a single figure for the actuarial present value of the officer's accumulated benefit under a plan, assuming retirement at normal retirement age under the plan and no increase in compensation from the date of calculation. Payments made under a plan are included only in the Pension Benefits Table and not the Summary Compensation Table.
- Disclosure about deferred compensation in the Nonqualified Deferred Compensation Table was adopted substantially as proposed. All earnings, whether or not above market, are included in the Nonqualified Deferred Compensation Table. The company must quantify in a footnote the extent to which amounts reported in this table are currently, or were previously, reported as compensation in the Summary Compensation Table. Payments of deferred compensation are included only in the Nonqualified Deferred Compensation Table and not the Summary Compensation Table.
- The rules provide certain assumptions for purposes of quantifying the amounts potentially payable upon termination of employment or a change in control of the company. The company should assume that the triggering event occurred as of the last business day of the last fiscal year and that the stock price is the closing market price on that date. The rules also made clear that benefits such as continued medical coverage and perquisites must be quantified.
- ***Valuation of equity-based awards.*** The rules retain the proposal's use of Financial Accounting Standard (FAS) 123R fair value determinations as the reported values for equity-based awards in the Summary Compensation Table. The rules also call for disclosure of the full grant value at the time of grant. Consistent with FAS 123R, however, the rules require disclosure of only the incremental value of equity-based awards that have been repriced or modified. The rules also require separate inclusion of dividends or other returns on awards only where those dividends or other returns have not been taken into account in making the valuation under FAS 123R.

- ***Expanded interpretive guidance about perquisites.*** The SEC retained the proposal’s general approach to perquisites but has provided more guidance about their classification as such.
  - The Release reconfirms the proposal’s approach that benefits “integrally and directly related to performance of the executive’s duties” are not perquisites even if not provided on a non-discriminatory basis to all employees. Citing laptops and Blackberry devices as examples, the SEC warns that the guidance will be narrowly construed. The distinction drawn is between items that the executive “needs . . . to do the job” and “an item provided for some other reason, even where that other reason can involve both company benefit and personal benefit.”<sup>5</sup> The Release also clearly specifies that company-provided commuting services and security systems at personal residences should be viewed as perquisites.
  - The Release reconfirms that, where an item is not integrally and directly related to performance and confers a personal benefit (regardless of whether it was provided for the company’s convenience), the question becomes whether the item is provided on a non-discriminatory basis to all employees. The Release clarifies that certain distinctions based on legal restrictions are not discriminatory. By contrast, if benefits to employees differ based on job category or compensation band, such benefits will not be considered non-discriminatory.
  - The Release reconfirms that the valuation methodology for perquisites is “aggregate incremental cost.” While this approach means that a company is not required to determine the fair market value of perquisites, it also means that it may not use alternative valuations such as the IRS Standard Industry Fare Levels (or SIFL) used to impute taxable personal income derived from travel benefits.
- ***Summary Compensation Table.*** The Release and final rules provide additional guidance about how payments and awards should be classified in the Summary Compensation Table. In particular, the Release and rules make clear that any amounts earned in a fiscal year must be disclosed in the appropriate column in the Summary Compensation Table for such year, whether or not deferred (with any amounts so deferred generally included in the Nonqualified Deferred Compensation Table) or subject to further forfeiture conditions. The Release also provides additional guidance regarding the distinction between short-term incentive payments and bonuses.

<sup>5</sup>

Release at 75.

- ***Other tabular disclosure.***
  - The two proposed supplemental tables to the Summary Compensation Table presenting equity-related and incentive compensation have been streamlined and combined into a single table.
  - Certain tabular disclosure about equity-based compensation must be given on a grant-by-grant basis, rather than in the aggregate, and with respect to both “out-of-the-money” and “in-the-money” options.
  - The rules clarify that amounts realized on transfer for value of equity-based awards must be disclosed in the Option Exercises and Stock Vested Table.
- ***Retention and relocation of performance graph.*** The performance graph illustrating stock performance, which the SEC had proposed to eliminate, is retained but will be included as part of disclosure regarding a company’s common equity securities under Item 201 of Regulation S-K.

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We plan to circulate in the near future a more comprehensive client memorandum discussing the new rules, their application and the practical issues that they raise. Please feel free to contact Alan L. Beller, A. Richard Susko, Janet L. Fisher, Arthur H. Kohn or Mary E. Alcock or any of our other partners and counsel listed under “Employee Benefits” or “Corporate Governance” in the “Our Practice” section of our website ([www.clearygottlieb.com](http://www.clearygottlieb.com)) if you have any questions.

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