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SEC Changes Stock-Based Compensation Disclosure Rules

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At the close of business today, the Securities and Exchange Commission (the "Commission") published a release (the "Release") adopting, as interim final rules, amendments to the requirements for disclosure by U.S. companies of executive and director compensation.[1]

The Release appears to have been adopted using the Commission's seriatim procedure and its adoption and publication were not the subject of any notice before today. The rules promulgated in the Release are interim final rules that are effective immediately upon publication in the Federal Register and will apply for the 2007 proxy season.[2] While the Commission has provided in the Release for a 30-day comment period, today's rules are final without requiring additional Commission action.

The Release substantially changes the manner in which stock-based awards will be reflected in the Summary Compensation Table and the Director Compensation Table in proxy statements. In general, the amount included in these tables for a stock-based award will reflect the expense of such award reported for financial reporting purposes in the relevant period under Financial Accounting Standard (FAS) 123R. The full grant date fair value of these awards, which under the prior rules was the amount reflected in these tables, will be reflected in the Grant of Plan-Based Awards Table and in footnotes to the Director Compensation Table. The Commission indicates that it has determined that this approach

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1 SEC Rel. No. 33-8765; 34-55009 (Dec. 22, 2006), which is available at http://sec.gov/rules/final/2006/33-8765.pdf, amending the final rules adopted in 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.

2 The Commission indicates that its bases for adopting the rules as interim final rules without requesting further comment include the fact that the various approaches to disclosing equity-based compensation were as part of the original comment process for the new executive compensation rules the subject of extensive comment, which the Commission considered in taking today's action, and its desire to have the interim final rules applicable for the 2007 proxy season.

provides clearer, more transparent and better disclosure for investors. The Release and the accompanying press release are attached for reference.

The principal consequences of the Release for stock-based awards are:

- For stock-based awards accounted for on an "equity" basis, companies will now be required to disclose in the Stock Awards and Option Awards columns in the Summary Compensation Table the compensation cost of the awards (before reflecting forfeitures) over the requisite service period, as described in FAS 123R, rather than immediately reflecting the cost in full in the year of grant. This change will significantly affect total compensation numbers, and could easily in some cases affect the determination of which executive officers are reported in the Summary Compensation Table.

- The full grant date fair value of stock-based awards will be disclosed on a grant-by-grant basis in the Grant of Plan-Based Awards Table reflecting grants of stock-based awards.

- For stock-based awards that are accounted for on a "liability" basis (such as cash-settled stock appreciation rights), companies will also be required to reflect increases and decreases in the value of the company's stock on a mark-to-market basis from year to year, with the result that decreases in stock price may decrease reported compensation.

- Notwithstanding the provisions of FAS 123R, estimates of forfeitures related to service-based vesting conditions will not be taken into account in calculating the amount of stock-based awards for the Summary Compensation Table. However, actual forfeitures will be reflected in the Summary Compensation Table at the time of forfeiture. Therefore, if a named executive officer forfeits an award, the amount of compensation cost previously disclosed in the Summary Compensation Table will be deducted in the period the award is forfeited. This could result, for example, in substantial reductions in total compensation for an employee severed during the year and whose stock-based compensation is forfeited, with the further result that such employee would be less likely to be included as one of the two additional individuals for which compensation is required to be reported in the Summary Compensation Table.

- For awards containing a performance-based vesting condition, FAS 123R requires companies to estimate at the grant date the portion of the awards that ultimately will be earned. These estimates affect reported expense under FAS 123R. Accordingly, under the Release, compensation reported for awards containing a performance-based vesting condition may change over time, if an assessment of the probability that performance conditions will be achieved changes. Such changes could result in disclosure of positive or negative compensation adjustments in years after the year of grant.

- Under the Release, in some cases, stock-based compensation could be decreased and in some cases could even be negative as a result of actual forfeitures, negative assessments as to the likelihood that performance conditions will be satisfied, or decreases in the value of the company's stock for awards accounted for on a "liability" basis.

- Companies will be required to utilize FAS 123R modified prospective transition methods for Item 402 disclosure purposes, with the result that certain awards granted prior to 2006 may be required to be reflected in the Summary Compensation Table, including for 2006, as well as thereafter.

Similar rules apply to the Director Compensation Table. The Release also changes reporting of compensation that may either be paid as cash or equity at the election of a named executive officer. Under the Release, any forgone cash must nevertheless be reported in the salary or bonus column of the Summary Compensation Table, with footnote disclosure referring to the Grant of Plan-Based Awards Table.

These amendments should be reviewed not only for proxy disclosure purposes but also for Internal Revenue Code Section 162(m) tax planning purposes.

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