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Executive Compensation & Related-Party Disclosure

SEC Releases Details of Executive Compensation and Related-Party Disclosure Rules

EXECUTIVE SUMMARY OF CHANGES FROM THE PROPOSAL

On Friday, the SEC released the details of its final rules revising the disclosure requirements applicable to executive compensation, director compensation, Form 8-K filings, related-party transactions and corporate governance matters. The final rules contain some changes but generally follow the SEC's January 2006 proposal, in response to which it received over 20,000 comment letters. Some of the major changes from the proposal are described below. The complete rule package is summarized on pages 5-8.

- ***Both CD&A and Compensation Committee Report Required.*** The final rules require both a new Compensation Discussion and Analysis that will be "filed" with the SEC and a shortened Compensation Committee Report.

  The shortened Compensation Committee Report will consist of a statement that the compensation committee has reviewed the CD&A with management and has recommended that the CD&A be included in the company's proxy statement. The new Compensation Committee Report will continue to be provided over the signatures of the compensation committee and be deemed to be "furnished" with the SEC (and therefore subject to a somewhat reduced potential liability regime).

  Because the CD&A is filed with the SEC, it will be subject to a company's disclosure controls and procedures and will be covered by the CEO and CFO certifications under the Sarbanes-Oxley Act. The SEC notes that the CEO and CFO will be able to look to the new Compensation Committee Report in providing their certifications relating to the CD&A.

- ***Additional Detail Regarding Confidential Information Required.*** The final rules permit companies to omit specific performance target levels if disclosure would result in competitive harm. However, if a company omits specific target levels, the final rules require discussion of how difficult it will be to achieve the undisclosed levels. We suggest that companies consider this new disclosure requirement in formulating targets and adopting new plans.

- ***Option Grant Disclosure.*** The final rules expand the disclosure of stock option grants and policies, requiring specific disclosure of below-market and "timed" options and any practices regarding the timing of option grants in relation to the release of material information. In particular, any policy that results in the exercise price of an option being less than the closing market price on the date of grant

will require additional disclosure, notwithstanding that the policy may be consistent with accounting and tax requirements. The disclosure applies to grants and policies in 2006 but generally not earlier.

- ***Termination and Change-in-Control Payments.*** The final rules continue to require disclosure of post-employment and change-in-control payments. In particular, the final rules confirm that quantification of both payments and benefits is required and provide that companies should assume the triggering event takes place on the last business day of the last fiscal year and the price per share is the closing market price on that date. The disclosure may require substantial time to complete, particularly if identifying and valuing gross-up obligations and non-cash benefits is necessary.

- ***Independence Disclosure Rationalized.*** The proposal would have required a description of each transaction – including immaterial transactions – considered by the board of directors in determining that a director is independent. In a significant change, the final rules require a description only of the *type* of transactions or relationships that were considered.

- ***Additional Employee Disclosure Reproposed.*** The proposed rules would have required compensation disclosure for up to three employees if their compensation exceeded that of the least-paid "named executive officer." The final rules do not include this requirement, but the SEC is requesting comment on a revised requirement that limits disclosure only to employees having responsibility for significant policy decisions within the company or a significant part of the company and that would apply only to large accelerated filers. We expect that this requirement will continue to generate significant comment and suggest that interested parties continue to participate in the comment process.

- ***Dividends on Restricted Stock and Market Earnings on Deferred Compensation Excluded from Summary Compensation Table.*** In a reversal from the proposal, the final rules generally exclude dividends on restricted stock and market earnings on nonqualified deferred compensation from the new summary compensation table. However, all earnings on nonqualified deferred compensation will be disclosed in the separate deferred compensation table.

- ***Determination of Named Executive Officers.*** The "named executive officers" in the proxy statement will be determined based on total compensation, but excluding increases in actuarial present value of pension benefits and earnings on nonqualified deferred compensation. However, increases in actuarial present value of pension benefits and above-market earnings on deferred compensation continue to be included in the new summary compensation table and in the total compensation figure in that table.

  In addition, severance and similar payments continue to be included in total compensation. As a result, it will be more likely that terminated executives will be among the named executive officers.

The new rules will generally apply to the 2007 annual proxy statements for companies whose fiscal year ends on or after December 15, 2006.

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SUMMARY OF THE FINAL RULES

The final rules represent the most extensive changes to executive compensation and related-party disclosure by U.S. public companies in over 13 years. The following is a summary of the more significant aspects of the final rules:

- ***Executive Compensation.*** The final rules divide the disclosure of executive compensation into four new sections:

  (1) ***A Compensation Discussion and Analysis that discusses the material factors underlying compensation policies and decisions and a related Compensation Committee Report***. The new CD&A, philosophically based on Management's Discussion and Analysis, is subject to the general disclosure and liability provisions of the federal securities laws and must discuss the following six items:

  1. The objectives of the compensation programs
  2. What the compensation program is designed to reward
  3. Each element of compensation
  4. Why the company chooses to pay each element
  5. How the company determines the amount (and, where applicable, the formula) of each element
  6. How each compensation element fits into the company's overall compensation objectives and affects decisions regarding other elements

  New to the final rules, companies must disclose any practices regarding the timing of option grants in relation to the release of material information, the board or compensation committee's role in administering the practices, management's role in option timing practices, and similar disclosure with respect to any practices resulting in the grant of options having an exercise price different from the closing price on the grant date.

  The new Compensation Committee Report is shortened and consists of a statement that the committee has reviewed the CD&A with management and has recommended that the CD&A be included in the proxy statement. The Compensation Committee Report continues to be provided over the signatures of the compensation committee. It is "furnished," not "filed," and therefore subject to a somewhat reduced potential liability regime.

  (2) ***A presentation of total compensation with respect to the current fiscal year and the prior two fiscal years***. The core of this section is a revised summary compensation table covering the principal executive officer, principal financial officer and next three highest-paid executive officers. The revised summary compensation table includes:

- A new total compensation column
- The fair value grant of all stock and stock-based awards, but generally not market earnings on outstanding awards
- Amounts earned under non-equity incentive plans, even if payable at a later date
- The change in the actuarial present value of pension benefits and above-market earnings on nonqualified deferred compensation

The highest paid officers are determined based on total compensation, but excluding increases in actuarial present value of pension benefits and earnings on nonqualified deferred compensation.

A supplemental table details grants of plan-based awards. The table requires additional columns if the exercise price of any options granted is less than the closing price per share on the date of grant or if the date of grant of an equity-based award is different from the date the compensation committee acts.

(3) ***A presentation of holdings of equity-related interests received as compensation***. This section includes a table detailing equity-related interests held at the end of the year and their value. A separate table details the value that each named executive officer realized during the year as a result of option exercises and restricted stock vesting.

(4) ***A presentation of retirement and other post-employment benefits***. This section includes a discussion quantifying potential severance and change-in-control benefits. For this purpose, companies must assume the triggering event occurs on the last day of the company's fiscal year and that the price per share is the closing price of the company's stock as of that date. This section also includes two new tables regarding the current actuarial value of pension benefits and the value of deferred compensation benefits.

The final rules also add new disclosure requirements for compensation committees' procedures and processes, including the identity of any compensation consultant involved in determining or recommending executive and director compensation.

The Annex to this memorandum outlines the required executive compensation disclosure.

- ***Director Compensation.*** The final rules revise the discussion of director compensation to include a new director compensation table that resembles the summary compensation table for named executive officers. Among other items, the director compensation table requires disclosure of perquisites, consulting fees and awards under director legacy and similar charitable awards programs.

- ***Form 8-K Disclosure of Executive Compensation Arrangements.*** The final rules significantly reduce the current disclosure of executive compensation arrangements on Form 8-K. As revised,

only material employment arrangements for named executive officers and material amendments need to be disclosed on Form 8-K. These arrangements and amendments for directors also need to be disclosed on Form 8-K in connection with their appointment or departure. Individual grants and awards do not need to be disclosed on Form 8-K if they are consistent with previously disclosed compensation plans.

- ***Related-Party Transactions.*** The final rules streamline the disclosure of related-party transactions, make the disclosure principles-based and increase the threshold for reporting transactions to $120,000.

  The SEC noted that the final rules may require the disclosure of business relationships that are not required to be disclosed under the current rules. This is the case because the final rules remove the specific standards applicable to business relationships and subject business relationships to the general $120,000 test. However, the SEC clarified that the $120,000 test must be combined with a materiality analysis of the interest of the related party in the transaction. In light of this guidance, we expect that the final rules will generally not expand the existing disclosure of business relationships.

  The final rules also require the disclosure of a company's policies and procedures for approving related-party transactions and as to whether any reportable transaction was not so reviewed.

- ***Corporate Governance Disclosure.*** The final rules consolidate and enhance corporate governance disclosure. In particular, the final rules require a description of the *type* of transactions or relationships that were not required to be disclosed as related-party transactions but that were considered by the board of directors in determining whether a director was independent.

- ***Disclosure of Pledges.*** The final rules require disclosure by footnote to the beneficial ownership table of all shares pledged by directors, named executive officers and directors and executive officers as a group.

- ***Plain English.*** The final rules require executive and director compensation disclosure to be in the SEC's plain English format.

- ***Non-U.S. Issuers.*** The final rules continue existing exceptions for non-U.S. SEC-reporting issuers. In addition, they limit the circumstances under which non-U.S. issuers must file employment agreements or compensation standards to mirror home country requirements.

- ***Registered Investment Companies.*** The final rules reorganize the proxy statement disclosure requirements for registered investment companies. In addition, consistent with the increased related-party transaction threshold applicable to operating companies, the final rules raise to $120,000 the threshold for disclosure of certain interests, transactions and relationships of disinterested directors and nominees.

- ***Timing and Transition.*** The new rules will generally apply to 2007 annual proxy statements for companies whose fiscal year ends on or after December 15, 2006 and to Securities Act registration statements filed or amended on or after that date. The new requirements with respect to the summary compensation table are to be phased in on a going-forward basis and do not require companies to restate disclosure relating to fiscal years prior to 2006. For example, the summary compensation table will include only one fiscal year's compensation information for the 2007 proxy season. An additional year of disclosure will be included over each of the next two years, until three full fiscal years are presented in the summary compensation table. The Form 8-K amendments are effective 60 days after the final rules are published in the *Federal Register*, expected later this month.

I. EXECUTIVE COMPENSATION DISCLOSURE

The final rules divide the discussion of executive compensation for U.S. companies into four new sections: (1) a Compensation Discussion and Analysis that discusses the material factors underlying compensation policies and decisions and a related Compensation Committee Report, (2) a presentation of compensation with respect to the last fiscal year and the two prior fiscal years, (3) a presentation of holdings of equity-related interests received as compensation, and (4) a presentation of retirement and other post-employment benefits, such as severance and change-in-control benefits.

The rules generally do not change the current rules regarding executive compensation disclosure for non-U.S. SEC-reporting issuers.

A. COMPENSATION DISCUSSION AND ANALYSIS

1. Overview of Material Elements of Compensation

The new Compensation Discussion and Analysis (CD&A) replaces the current Compensation Committee Report, although a shortened Compensation Committee Report will remain.[1] The CD&A is intended to provide an overview that puts into context the compensation disclosure by explaining the material elements of the company's compensation for named executive officers and describes each of the following:

1. The objectives of the compensation programs
2. What the compensation program is designed to reward
3. Each element of compensation
4. Why the company chooses to pay each element
5. How the company determines the amount (and, where applicable, the formula) of each element
6. How each compensation element fits into the company's overall compensation objectives and affect decisions regarding other elements

In response to comments, the final rules omit the requirement that companies describe what the compensation program is *not* designed to reward.

[1] In a change from the proposed rules, the final rules retain the Performance Graph but this requirement is moved to the disclosure rule covering the market price of common equity and related matters.

The final rules provide fifteen examples of the topics potentially appropriate for the CD&A, although the final rules stress that the topics addressed by the CD&A are principles-based and that not all examples will apply in all cases. Two new examples added in the final rules are:

- Company policies and decisions regarding the adjustment or recovery of awards or payments if the relevant performance measures on which they are based are otherwise adjusted or restated
- For agreements providing post-termination benefits, the basis for selecting particular triggers (*e.g.*, the rationale for providing single trigger for payment on a change in control)

Other examples include:

- The role of executive officers in setting compensation
- The factors considered in decisions to increase or decrease compensation materially
- Benchmarking of compensation and the companies forming the benchmark
- Equity ownership guidelines or requirements and policies regarding the hedging of the economic risk of that ownership
- Items of company performance that are taken into account in setting compensation policies and how specific forms of compensation are structured to reflect these performance items and the executive's individual performance (including whether discretion can be or has been exercised, identifying any particular exercise of discretion and stating whether it applied to one or more specified named executive officers or to all compensation subject to the relevant performance goal)
- How prior compensation is treated in setting other elements of compensation
- The impact of the accounting and tax treatments of the particular forms of compensation[2]
- For long-term compensation, the basis for allocating compensation to each different form of award
- How the determination is made as to when awards are granted, including awards of equity-based compensation such as options
- Policies for allocating between (1) immediate and long-term compensation, (2) cash and non-cash compensation and (3) different forms of non-cash consideration

[2] The SEC commentary accompanying the final rules states that this example should include a company's Internal Revenue Code Section 162(m) policy, consistent with the prior rules, as well as any other tax or accounting treatment that is material to a company's compensation policy or decisions with respect to the named executive officers.

The final rules clarify that the CD&A must address both the last fiscal year and actions taken after the fiscal year-end. In addition, it may be necessary in some situations to discuss prior years to give context to the disclosure provided.

The SEC commentary that accompanies the final rules indicates that the CD&A should be sufficiently precise to identify material differences in policies and decisions for individual executives where appropriate. Although policies may be grouped together if materially similar, separate discussions are required if there are material differences.

2. Options Disclosure

The SEC commentary notes that the SEC believes the CD&A should disclose the existence of any policy or practice to time the grant of stock options in coordination with material non-public information. In particular, the SEC believes that any company with such a policy or practice should disclose that the compensation committee may grant options at times when the company is in possession of material non-public information. The SEC also provides a list of the following questions that it believes companies should address when drafting the corresponding disclosure:

- Does the company have any policy or practice to time option grants to executives in coordination with the release of material non-public information
- Has the company timed the release of material non-public information in order to affect the value of executive compensation
- Does the company set its grant of options to new executives in coordination with the release of material non-public information
- How does the policy or practice fit in the context of the company's policy or practice with regard to options grants to employees generally
- What is the role of executive officers in the company's policies or practice of option timing
- What is the role of compensation committees in approving and administering such policies and did the committee delegate any aspect of the actual administration of such policy or practice

In addition, the SEC commentary requires companies to describe any decision since the beginning of the past fiscal year to time option grants if the company has not previously disclosed a policy or practice of timing options.

3. Disclosure of Confidential Commercial or Business Information

The final rules permit companies to omit target levels with respect to specific performance-related factors considered in the compensation process if the disclosure would result in competitive harm to the company. However, if the company omits specific quantitative or qualitative factors, the company must discuss how difficult it will be for the executive or the company to achieve the undisclosed target levels.

The final rules have been revised to apply the same standard to the CD&A as the one used when companies request confidential treatment of trade secrets and information that otherwise is required to be disclosed in documents filed with the SEC, although no request for confidential treatment is required. Accordingly, information may not be omitted if it has otherwise been disclosed publicly. In addition, the SEC commentary accompanying the final rules states that the CD&A is subject to review by the SEC and that, as a result of the review, the SEC may require a company to demonstrate the need for confidentiality.

The new rules provide that disclosure of a target level that applies a non-GAAP financial measure will not be subject to the general rules regarding disclosure of non-GAAP financial measures. However, a company must disclose how the target level is calculated from the audited financial statements.

4. Subject to General Disclosure and Liability Provisions

Unlike the current Compensation Committee Report, the CD&A will be deemed "filed" with the SEC and therefore be subject to the general disclosure and liability provisions of the Securities Act and the Exchange Act. As a result, the CD&A will also be subject to the CEO and CFO certifications required by the Sarbanes-Oxley Act, because these disclosures are incorporated by reference into Form 10-K (or, in limited cases, included directly in the Form). The SEC notes that the CD&A is intended to discuss the company's compensation policy and decisions and does not address deliberations of the compensation committee. Accordingly, the SEC states that CEOs and CFOs are not being called upon to certify compensation committee deliberations. In addition, the SEC states that the CEO and CFO will be able to look to the new Compensation Committee Report in providing their certifications.

The SEC also notes that a company's disclosure controls and procedures apply to the preparation of the company's proxy statement, including the CD&A.

B. COMPENSATION COMMITTEE REPORT

The final rules retain a shortened Compensation Committee Report. This report must contain a statement describing whether the compensation committee has reviewed and discussed the CD&A with management and, based on that, recommended that the CD&A be included in the company's annual report and proxy statement. Consistent with current requirements, the Compensation Committee Report is provided over the signatures of the compensation committee and deemed to be "furnished" with the SEC. The Compensation Committee Report is therefore subject to a somewhat reduced potential liability regime and is not covered by the CEO and CFO certifications. The Report remains subject to private liability, though, under the general antifraud provisions of the federal securities laws.

C. TOTAL COMPENSATION IN THE LAST THREE FISCAL YEARS

A revised summary compensation table serves as the principal disclosure vehicle regarding executive compensation paid in the last three fiscal years. This table shows the named executive officers' total

compensation for each of the last three years, whether or not actually paid out. The form of the new summary compensation table, together with the other tables discussed in this memorandum, is included in the Annex.

1. New Reported Employees

a. Principal Executive Officer, Principal Financial Officer and Three Other Most Highly Compensated Executive Officers

The final rules change the "named executive officers" for whom compensation disclosure is required. Currently, companies must provide information for the chief executive officer and the four other most highly compensated executive officers.[3] The final rules change the named executive officers to the principal executive officer, the principal financial officer,[4] and the three other most highly compensated executive officers. Accordingly, even if a company's principal financial officer is not one of the five most highly compensated executive officers, he or she must be included in the revised summary compensation table. Moreover, consistent with the current treatment of principal executive officers, anyone who served as principal financial officer *at any time* during the last fiscal year must be included in the summary compensation table.

b. Determination of Most Highly Compensated Executive Officers

The final rules require determination of the most highly compensated executive officers on the basis of total compensation for the last fiscal year, *excluding* changes in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation. Currently, the determination is based solely on salary and bonus.

As a result of this change, companies will need to track a great number of compensation elements to identify the named executive officers. In addition, executives who receive severance will be more likely to be included among the named executive officers because severance and similar termination-related payments are included in the calculation of total compensation.

The final rules eliminate the ability to exclude compensation that is "non-recurring and unlikely to continue"[5] so that these amounts must be included in determining whether an executive was one of the

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[3] *See* Item 402(a)(3). Item 402(a)(3) also requires disclosure for up to two additional individuals for whom disclosure would have been required (because they were among the four other most highly compensated individuals) but for the fact that the individual was no longer serving as an executive officer at the end of the most recent fiscal year. The final rules continue this requirement.

[4] "Principal executive officer" and "principal financial officer" correspond to the terms used in Item 5.02 of Form 8-K.

[5] *See* Instruction 3 to Item 402(a)(3).

highest-paid executive officers. The final rules, however, retain the ability to exclude cash compensation relating to overseas assignments in determining the named executive officers.

c. Non-Executive Employees

The proposed rules would have required compensation disclosure for up to three employees if their compensation exceeded that of the least-paid named executive officer. That disclosure would have included only the employees' total compensation and job positions – the employees would not have had to be named.

This aspect of the proposal generated significant comment, and the final rules do not include that requirement. Instead, the SEC is requesting additional comment on a revised requirement that would limit disclosure to those non-executives having responsibility for significant policy decisions within the company, within a significant subsidiary or within a principal business unit, division or function. The reproposed rule describes that authority as possibly consisting of the exercise of strategic, technical, editorial, creative, managerial or similar responsibilities, such as the director of a news division of a major network, the principal creative leader of the entertainment function of a media conglomerate or the head of a principal business unit developing a significant technological innovation. The SEC specifically mentions that investment professionals, including traders, portfolio managers and investment advisors are excluded if they are performing only functions generally associated with those jobs. The SEC has requested further comment and has indicated that it might limit the disclosure to large accelerated filers.[6] Among its requests for comment, the SEC has requested comment on whether the three non-executives should be named.

We expect that the SEC's reproposal will continue to generate significant comment. Comments are due in October, 45 days after the final rules are published in the *Federal Register*. Presumably, the SEC intends to issue a final rule in sufficient time to apply to 2007 proxy statements.

2. Revisions to the Summary Compensation Table

a. Total Compensation Column

The final rules add a new "total" column to the summary compensation table. Unlike the proposal, this column is the final quantitative column in the table. It totals the compensation described in each of the table's other columns – salary, bonus, stock awards, option awards, non-equity incentive plan compensation, changes in pension and nonqualified deferred compensation earnings and all other compensation.

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[6] As defined in Exchange Act Rule 12b-2.

b. Salary and Bonus

The salary and bonus columns of the current summary compensation table are retained under the final rules with three changes from the current rules.

The most significant change is that compensation that is currently included in the bonus column may be moved to the new "non-equity incentive plan compensation" column. As a result of comment, the final rules eliminate the distinction between "long-term compensation" and annual bonuses and instead distinguish between "incentive plan compensation" and discretionary bonuses. Under the final rules, a cash award based on a performance target that is substantially uncertain at the time it is established and communicated to the executive should be reported in the new non-equity incentive plan column. This is the case whether the performance period is more or less than one year. The bonus column under the final rules will include only cash awards that are based on satisfaction of a performance target that is not pre-established and communicated or the outcome of which was substantially certain at the time it was communicated.

The second change is that all compensation that is earned but deferred must be included in the salary, bonus or other column, as appropriate. This applies to deferrals for any reason, not just deferrals at the election of the executive. As described below, the amount deferred generally will also be reflected as a contribution in the deferred compensation presentation.

Third, the final rules require footnote disclosure if a named executive officer's salary or bonus is not determinable as of the time the proxy statement or other disclosure document is filed. Currently, such amounts must be reported in the Form 10-K or proxy statement for the following fiscal year. The final rules instead require footnote disclosure to the summary compensation table noting when the calculation is expected to be made and further require companies to report on Form 8-K the amount when it becomes calculable.

c. Stock Awards

The final rules replace the existing "restricted stock awards" column with a new "stock awards" column that includes all stock-related awards deriving their value from the company's equity securities or permitting settlement in those securities, other than awards that have option-like features. Awards reflected in this column include restricted stock, restricted stock units, phantom stock, phantom stock units and similar instruments. The value for these awards is based on their grant date fair value as determined pursuant to FAS 123R for financial reporting purposes. In applying FAS 123R, the recipient

must apply the same valuation model and assumptions as it does for financial statement reporting purposes.[7]

Currently, companies may elect to include stock awards subject to performance conditions in a separate LTIP table as opposed to the summary compensation table.[8] The final rules eliminate this option and require companies to include the grant date fair value of these awards in the stock awards column of the summary compensation table.

The proposed rules had included a requirement that all earnings on stock awards, such as dividends or dividend equivalents, be included in the stock awards column when paid. As a result of comments, including a comment from us, the SEC has concluded that separate inclusion of those payments would be double counting to the extent future earnings are factored into the grant-date fair value computed under FAS 123R. Accordingly, the final rules require disclosure of earnings on stock awards when paid (in the "all other compensation" column discussed below) only if they were not factored into the grant date fair value previously disclosed in the summary compensation table.

d. Option Awards

Awards of options, stock appreciation rights and other similar instruments with option-like features must be disclosed in an "option awards" column in a manner similar to the treatment of stock awards. Instead of the current disclosure of the number of securities underlying the awards, this column requires disclosure of the grant date fair value of the award as determined pursuant to FAS 123R for financial reporting purposes.[9]

The SEC had proposed that the option awards column would have included the *total* value of any options or stock appreciation rights that were repriced or materially modified during a year. As a result of comments, the final rules require inclusion of only the incremental value resulting from a repricing or material modification, consistent with the treatment of these actions under FAS 123R.

e. Non-Equity Incentive Compensation

A new column reports the value of all other amounts *earned* (not granted) pursuant to non-equity incentive plans.[10] This column is limited to awards where the relevant performance measure is not based

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7 The final rules require a footnote referencing the discussion of the relevant assumptions in the notes to the company's financial statements or MD&A.

8 For this purpose, a performance condition is defined by reference to FAS 123R.

9 The final rules codify the SEC staff's current position that options that have been transferred, for example, by gift to a family limited partnership, must still be included in the summary compensation table.

10 "Non-equity incentive plan" is defined as any incentive plan that is not an incentive plan under which awards are granted that fall within the scope of FAS 123R.

on the value of the company's equity securities and the award may not be settled in company stock.[11] The amounts are to be disclosed in the summary compensation table for the year in which the performance goals were met and the awards vested, regardless of whether the amounts were actually paid.

The final rules require any earnings on outstanding non-equity incentive compensation during a year to be reported in the non-equity incentive compensation column and identified in a footnote. As a result, it appears that market earnings on outstanding non-equity incentive awards must be included in the summary compensation table even though the same earnings on other deferred compensation would not be included.

f. Pension Benefits and Deferred Compensation Earnings

The final rules add a new column quantifying the yearly increase in the actuarial value of defined benefit retirement plans and any above-market or preferential earnings on deferred compensation that is not tax-qualified. Footnote identification and quantification of the full amount of each element is required. Under the proposed rules, these amounts would have been included in the "all other compensation" column, but, in order to facilitate subtracting them from total compensation for purposes of determining the most highly-paid officers, the final rules place them in their own column.

Disclosure of the increase in pension value is required for any defined-benefit retirement or post-retirement plan, *including* tax-qualified plans. The increase must be calculated from the pension plan measurement date used for the company's audited financial statements for the prior completed fiscal year to the measurement date for the audited financial statements for the covered fiscal year. The disclosure therefore includes the increase (or decrease) in value due to additional years of service, compensation changes and plan amendments, as well as changes due to interest and other earnings assumptions. If the amount attributable to defined-benefit plans is negative for a year, the final rules require that the amount be disclosed by footnote but not included in the column. The requirement to include increases in pension value will likely require the assistance of persons not historically involved in the production of the proxy statement (such as actuaries), and companies should consider whether extra lead time will be required to produce the required information going forward.

Earnings on nonqualified deferred compensation are included in the summary compensation table only to the extent they are above-market or preferential. This is consistent with the current requirement, although the SEC's proposal would have required that all earnings be included. All earnings on nonqualified deferred compensation must be disclosed in the nonqualified deferred compensation table discussed

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[11] In some cases, this bifurcation of awards may result in different disclosure of performance shares and performance units in circumstances where they deliver the identical compensation.

below, but will not be reflected in either the total compensation column of the summary compensation table or in determining the named executive officers.

g. All Other Compensation

The next column in the revised summary compensation table discloses *all* compensation that is not included in another column and not specifically permitted to be excluded. Compensation that must be reflected includes:

- The value of perquisites and other benefits, unless the aggregate amount of such compensation is less than $10,000. Currently, this value is not required to be included unless it totals the lesser of $50,000 and 10% of annual salary and bonus. Unless the total of a named executive officer's perquisites is less than $10,000, companies are required to provide footnote disclosure identifying each particular perquisite and, if the value of the perquisite is at least $25,000 or 10% of the total perquisites, its value. Currently, only perquisites that are 25% of the total perquisite value to a named executive officer must be identified and valued.

- The dollar value of any life insurance premiums paid by the company for the benefit of a named executive officer. Currently, compensation includes only the value of term life insurance, premiums paid during the year and remaining premiums where the named executive has an interest in the policy's cash surrender value.

- Amounts paid or accrued pursuant to any plan or arrangement in connection with any termination, including through retirement, severance or constructive termination, or a change in control of the company. (The final rules note that benefits under defined-benefit plans that are accelerated as a result of a change in control are reportable as "all other compensation.")

- Tax gross-ups or other tax reimbursements.

- Discounted security purchases, unless the discount is available generally to all security holders or all salaried employees of the company.

Any item included in the "all other compensation" column with a value of $10,000 or more needs to be identified and valued in a footnote (other than perquisites, which are subject to the special rule described in the first bullet above). In addition, as is the case today, tax gross-ups must be separately identified and quantified in the tax reimbursement category regardless of amount. If a named executive officer is also a director who receives compensation for his or her services as a director, the compensation must also be reflected in the summary compensation table and itemized in a footnote.

h. Interpretive Guidance as to Perquisites

After considering comments suggesting alternatives, including proposals to use current market values, the final rules continue to provide that aggregate incremental cost to the company is the proper measure of value of perquisites and other personal benefits.[12] To improve investors' ability to compare the

[12] Use of the amount attributed to perquisites for tax purposes is specifically not permitted unless, independently of the tax characterization, it constitutes incremental cost to the company.

perquisites among companies, the final rules add a new requirement to provide footnote disclosure of the methodology for computing the aggregate incremental cost of perquisites.

The SEC commentary accompanying the final rules contains new interpretive guidance from the SEC staff as to identifying and disclosing perquisites. The SEC suggests that companies first analyze whether an item is "integrally and directly related" to the performance of the executive's duties. If it is, then the item is not a perquisite. If not, the guidance states that the item is a perquisite 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 the item is generally available on a non-discriminatory basis to all employees.

The SEC mentions Blackberries and laptop computers as examples of items that may be integrally and directly related to the performance of duties. On the other hand, use of a company aircraft for personal travel or of company property for vacation is not integrally and directly related, even if provided for security purposes. The SEC commentary notes that, if an item is integrally and directly related to the performance of duties, there is no requirement to disclose any incremental cost over a less expensive alternative. For example, with respect to business travel, it is not necessary to disclose the cost differential between renting a mid-sized car versus a compact car.

The SEC commentary also provides guidance as to whether an item is "generally available on a non-discriminatory basis to all employees." The SEC states that a company may reasonably conclude that an item is generally available to all employees on a non-discriminatory basis if it is available to those employees to whom it may lawfully be provided. As an example, a benefit limited by an employee's status as an "accredited investor" may still be provided on a non-discriminatory basis. On the other hand, the SEC notes that merely providing a benefit consistent with its availability to employees in the same or higher job category is not sufficient to establish that the benefit is generally availably to all employees.

The SEC commentary accompanying the proposed rules contained substantial guidance as to identifying and disclosing perquisites, which continues under the new rules. This guidance is discussed in our January 30 memorandum to clients entitled "Executive Compensation Disclosure: SEC Staff Issues Strict Guidance Regarding Perquisites that Affects 2006 Proxy Season."

3. New Supplemental Table Detailing Grants of Plan-Based Awards

The final rules consolidate the proposed supplemental tables of performance-based awards and all other equity-based awards into one new supplemental table for all plan-based award grants. This table follows the summary compensation table and contains information about awards granted during the year that are based on an incentive plan or are otherwise contingent on the achievement of performance goals.

This table shows the terms of all grants made during the current year, including estimated future payouts for threshold, target and maximum performance for both equity incentive plans and non-equity incentive

plans, with separate disclosure for each grant. The final rules remove the requirement for tabular disclosure of vesting dates and/or performance periods, option expiration dates and whether consideration was paid for the award. Instead, those items (other than option expiration dates) would need to be disclosed in the accompanying narrative. The final rules require separate disclosure for each grant (including options) and, if awarded under more than one plan, each relevant plan. Separate disclosure is also required for any repricings of options or stock appreciation rights that may have occurred during the last fiscal year. Footnotes accompanying the table must disclose material terms of the awards (such as a reload or tax-reimbursement feature or a feature allowing the exercise price of the award to be lowered).

An additional column disclosing the market price on the date of grant must be added if the exercise or base price of an award is less than the closing market price of the underlying security on the date of grant. This is the case even if the exercise price is based on a "fair market value" formula that may be consistent with accounting and tax requirements. The final rules define "closing market price" as the price of the last sale on the principal US market for the relevant security and "date of grant" as the grant date determined for purposes of FAS 123R. If the exercise or base price differs from the market price on the date of the grant, additional footnote disclosure also is required regarding the methodology used in arriving at the price.

In a new development, an additional column must be added to the table to the extent the grant date differs from the date on which the relevant board committee took action or is deemed to have taken action to grant an equity-based award. The new column must show the date of committee action.

4. Narrative Disclosure

The final rules require narrative disclosure to give context to the summary compensation table and the grants of plan-based awards table. Unlike the CD&A, which the final rules indicate should focus on broader topics of executive compensation policies, the narrative disclosure focuses on the quantitative disclosure in the tables. The narrative disclosure describes any material factors necessary to understand the tables, including material terms in employment agreements. Other factors that the SEC notes could be material include:

- Option repricings or significant changes to outstanding awards[13]
- Material terms of awards reported in the plan-based award table, including any performance or market conditions (as defined in FAS 123R) that may apply, a description of the formula or criteria to be applied in determining the amounts payable and the vesting schedule
- Extension of exercise periods and changes to vesting, forfeiture or performance conditions

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[13] As a result of this new disclosure, the final rules eliminate the 10-year repricing table currently required by Item 402(i).

- Whether dividends are payable on the awards and at what rate
- Level of salary and bonus in proportion to total compensation

The final rules depart from the proposal in not suggesting that assumptions underlying the determination of the increase in the actuarial value of defined benefits plans could be appropriate subjects for narrative disclosure. Instead, the final rules require discussion of these assumptions in connection with the pension benefits table described below.

D. OUTSTANDING AND EXERCISED EQUITY AWARDS

The next section of executive compensation disclosure relates to holdings of previously awarded equity and amounts realized on previously awarded equity compensation during the last fiscal year. The new disclosure replaces the current aggregate option/SAR exercise table and fiscal year-end option/SAR value table.

1. New Table Detailing Outstanding Equity Awards at Fiscal Year-End

The first new table in this section discloses information regarding outstanding equity awards and the market-based values of the awards as of the fiscal year-end. The final rules depart from the proposed rules in requiring separate disclosure of option exercise prices and expiration dates for each instrument, rather than on an aggregate basis. The final rules also require footnote disclosure of vesting dates, and, if an option has an expiration date after year-end but before the date of disclosure, whether the options have been exercised.

Despite comments, the final rules continue to include performance awards in the outstanding equity awards table. For purposes of the table, companies are instructed to assume threshold performance goals (rather than target or maximum), unless the previous fiscal year's performance has exceeded the threshold. In that case, disclosure is to be based on the next higher performance measure (target or maximum) that exceeds the previous fiscal year's performance. If the target amount is not determinable, registrants must provide a representative amount based on the previous fiscal year's performance.

2. New Table Detailing Option Exercises and Restricted Stock Vesting

The second table in this section discloses the amounts realized on the exercise of options, SARs and similar instruments and the vesting of restricted stock, restricted stock units and similar instruments during the last fiscal year. The table must describe the value realized upon exercise or vesting (broken down by options/stock appreciation rights and restricted stock/units). In addition, amounts realized on transfers of awards for value would also need to be included in the table. Unlike the proposal, under the final rules, the grant date fair value need not be disclosed.

E. POST-EMPLOYMENT COMPENSATION

The final rules significantly revise the disclosure of post-employment compensation. They replace the existing pension plan table[14] with a new table detailing defined benefit pensions payable to named executive officers. They also add a new table regarding nonqualified defined contribution plans and other deferred compensation. Finally, the rules require more detailed narrative disclosure of compensation arrangements triggered on termination of employment or a change in control, including estimates of potential payouts.

1. New Table Detailing Pension Benefits

This new table discloses the value of defined pension benefits for each named executive officer. The table includes all qualified and nonqualified defined benefit plans and supplemental employee retirement plans, but excludes qualified and nonqualified defined contribution plans. Separate disclosure is required for each plan, although it remains unclear why separation is material.[15]

The final rules differ from the proposal in that they require quantification of the defined benefits by reference to the actuarial present value of the accumulated benefits.[16] This disclosure applies without regard to the particular form of benefit payable under the plan. The table also includes years of service recognized under each plan and pension benefits paid during the last fiscal year.

The table is followed by narrative disclosure of any material factors necessary to understand the benefits payable under the plans. In particular, the final rules give examples of these factors, including the material terms of the plans, types of compensation used in the benefit formula, different purposes for different plans and company policies regarding granting extra years of service under plans.

2. New Table Detailing Nonqualified Deferred Compensation

The second new table in this section discloses contributions, earnings and balances under nonqualified deferred compensation plans. This is a very significant change from the current rules which only require disclosure of earnings on nonqualified deferred compensation where the return is preferential or above-market.[17]

Footnote disclosure must indicate the amount of contributions and earnings previously reported in the summary compensation table and the extent to which amounts reported in the aggregate balance column

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[14] *See* Item 402(f).

[15] The SEC suggested that pensions under multiple plans will need to be discussed in the accompanying narrative.

[16] The amount is to be computed as of the same pension plan measurement date for the company's audited financial statements for the last completed fiscal year.

[17] *See* Instructions 3 and 4 to Item 402(b)(2)(iii)(C).

were reported in previous years' summary compensation tables. Combined with the required footnote disclosure in the summary compensation table regarding deferred amounts, the SEC believes that this footnote disclosure in the deferred compensation table of previously reported contributions and earnings will prevent investors from double counting deferred amounts.

The table is followed by narrative disclosure of any material factors necessary to understand the tabular disclosure. Examples of these factors may include:

- Types of compensation permitted to be deferred and limitations on deferral rights
- Methods of calculating interest or other earnings (including whether the named executive officer or the company is permitted to select the method and how and how often such selections may be changed)
- Material terms with respect to payouts, withdrawals and other distributions

3. Severance and Other Potential Post-Employment Payments and Benefits

The final rules add specific disclosure requirements for all arrangements that provide for payments or benefits in connection with a named executive officer's termination of employment, a change in his or her responsibilities or a change in control of the company. At the core of the requirement, companies must quantify the estimated payments and benefits in each covered circumstance.[18] Perquisites and other personal benefits must be identified and quantified unless under $10,000. For this purpose, health care benefits are specifically included as benefits and must be quantified using the assumptions used for financial reporting purposes.

The final rules also require companies to disclose the particular circumstances that would trigger payments or benefits, whether payments would be lump sum or annual and who would be responsible for them, how payment levels are determined under different triggers, material conditions to payments (*e.g.*, non-competes) and any other material factors. The SEC commentary accompanying the final rules specifically states that the item contemplates the disclosure of tax gross-up payments. Disclosure also is required if an executive simultaneously would receive both severance and retirement benefits.

The quantification of these payments is one of the major items that had been expected to be included in the new rules, and one that very few companies have attempted to date. This may reflect, in part, that the assumptions needed to derive an amount could substantially change the result. To provide

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[18] If a triggering event has occurred for a named executive officer and he or she is not serving as a named executive as of fiscal year-end, disclosure is required only for the actual triggering event that occurred. In addition, disclosure under this item is not required for payments or benefits that are fully disclosed in connection with the previous two tables. However, if the payment or benefit would be enhanced, the enhancement must be disclosed. Information also is not required for arrangements to the extent they do not discriminate in scope, terms or operation in favor of executive officers and are available generally to all salaried employees.

comparability, the final rules require companies to assume that the triggering event took place on the last business day of the fiscal year and the price per company share was the closing market price on that date. If other uncertainties exist, the final rules require a reasonable estimate (or a reasonably estimated range of amounts) and disclosure of the material underlying assumptions. The final rules specifically recognize that forward-looking information may be required.

Quantifying the amounts is likely to be time consuming and difficult, because disclosure for each named executive officer is required and because quantitative disclosure is required for perquisites and other benefits. This will particularly be the case for a company's first year of compliance. We therefore strongly recommend that companies consider preparing for this disclosure as soon as practicable.

II. DIRECTOR COMPENSATION DISCLOSURE

The final rules revise the discussion of director compensation to include a new director compensation table that resembles the summary compensation table for executive officers but presents information only with respect to the company's last fiscal year. The table is designed to encompass all director compensation and is to be accompanied by narrative disclosure of additional material information. The SEC commentary accompanying the final rules notes that disclosure regarding option timing or dating practices (as described above) may be necessary if directors receive stock options.

The final rules identify several items that must be reflected in the "all other compensation" column of the director compensation table and separately identified and quantified in a footnote if over $10,000. Some of the most significant include:

- The value of perquisites and other personal benefits unless the aggregate amount of such compensation is less than $10,000
- Awards under director legacy or charitable awards programs
- Consulting fees
- All tax reimbursements
- Discount stock programs not generally available to employees
- Contributions or allocations to qualified or nonqualified defined contribution plans
- The value of any life insurance premiums paid by the company for the directors' benefit
- Payments in connection with the director's resignation, retirement or termination or the change in control of the company

Additionally, the final rules require footnote disclosure of equity awards outstanding at the end of the last fiscal year. If all directors' compensation is identical, the rules allow for the grouping of information for all directors in one row.

III. FORM 8-K DISCLOSURE OF EXECUTIVE COMPENSATION

The final rules limit the Form 8-K triggers based on executive compensation arrangements, permitting the proxy statement to become the primary vehicle for the disclosure of executive officer and director compensation information. Following the 2004 amendments to Form 8-K,[19] reporting companies have been required to disclose an expanded number of events. The SEC commentary accompanying the final rules notes that, as a result of this expansion, Form 8-K has triggered compensation disclosure of matters "that do not appear always to be unquestionably or presumptively material."

The final rules move employment compensation arrangements from Item 1.01 of Form 8-K[20] to Item 5.02 and narrows the scope of arrangements triggering an 8-K filing. Currently, Item 5.02 requires disclosure within four business days of the appointment or departure of directors or specified officers.[21] The revised Item 5.02:

- Includes information regarding retirement, resignation or termination of any named executive officer for the last fiscal year, even if he or she had not been a specified officer for purposes of Item 5.02.
- In respect of any named executive officer, includes a brief description of any *material* new compensatory plan, contract or arrangement, or *material* new grant or award thereunder, or any *material* amendment. Grants and awards do *not* need to be disclosed if they are either immaterial or consistent with the terms of previously disclosed plans or arrangements and are eventually disclosed when required in the proxy statement. Similarly, modifications to outstanding awards need not be disclosed under Item 5.02 if they are consistent with previously disclosed plans or arrangements. No distinction should be made between awards granted under cash or equity-based plans.
- In respect of any specified officer (other than a named executive officer) or director who is newly appointed or departs, includes a brief description of any *material* plan, contract, or arrangement that is entered into or materially amended in connection with his or her appointment or departure or any grant or award to such an individual in connection with appointment or departure.

No Form 8-K disclosure is required with respect to director compensation other than in connection with his or her appointment or departure. The SEC commentary emphasizes that the expanded Item 5.02 requires only a brief description of the relevant matter and is not intended to require an updating of Item 402 disclosure.

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[19] See *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*, Release No. 33-8400 (Mar. 16, 2004); Sullivan & Cromwell LLP, *SEC Accelerates Form 8-K Filing Deadline and Expands Current Disclosure Requirements* (Mar. 23, 2004).

[20] The elimination is also effective in respect of Item 1.02, which references Item 1.01's "material definitive agreement" definition.

[21] These specified officers are the company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer and anyone performing similar functions.

Commenters had suggested that companies might find it difficult to identify named executive officers during the period after fiscal year-end but before preparation of their proxy statements. The final rules clarify that, for purposes of Item 5.02, named executive officers are the persons for who disclosure was required in the most recent SEC filing that required disclosure of a summary compensation table under Item 402 of the Regulation S-K.

A safe harbor from general antifraud liability under the Exchange Act had been extended to failures to timely file reports under, among other things, Item 1.01 of Form 8-K if the company included the relevant information with its applicable quarterly or annual report. The final rules extend a similar safe harbor to Item 5.02 disclosure of material new compensatory plans, awards, or amendments (that are not related to a specified officer's appointment or departure). This extension also continues the protection in respect of Form S-3 eligibility that had been afforded companies that fall within the safe harbor.

IV. RELATED-PARTY DISCLOSURE

The final rules contain significant revisions of related-party disclosure. Item 404(a) of Regulation S-K is revised to contain a general disclosure requirement for related-party transactions, including those involving indebtedness.[22] Existing Item 404(b) is deleted and replaced with disclosure regarding the company's policies and procedures for the review, approval or ratification of related-party transactions. Existing Item 404(c), having been moved to Item 404(a), is replaced with disclosure regarding promoters of a company.

A. GENERAL DISCLOSURE REQUIREMENT

The revised Item 404(a) requires disclosure if:

- a company is a "participant",
- in a "transaction" (or a proposed transaction) since the beginning of the last fiscal year, where
- the amount involved exceeds $120,000, and
- any "related person" had, or will have, a direct or indirect material interest.

The final rules are different from current Item 404(a) requirements in that they:

- call for disclosure if the company is a "participant," rather than a "party,"
- increase the current $60,000 threshold to $120,000,
- include a defined term for "transaction" to make clear its broad scope, and

[22] Personal loans to an executive officer or director by a company may raise questions under Section 402 of the Sarbanes-Oxley Act of 2002, which prohibits companies from extending credit in the form of a personal loan to an executive officer or director.

- include a single defined term for "related persons."

This general disclosure requirement replaces the disclosure of business relationships under current Item 404(b) and encompasses, through the new definition of transaction, the disclosure of indebtedness required under current Item 404(c).[23]

1. Determination of Material Interest

The final rules eliminate instructions regarding how materiality of an interest is to be determined[24] and clarify that non-disclosure is authorized if an interest is not a direct or indirect material interest. The SEC commentary states that, by omitting these instructions, the SEC did not intend to change the materiality standard applicable to Item 404(a). In particular, the SEC commentary accompanying the final rules states that the materiality of any interest will continue to "be determined on the basis of the significance of the information to investors in light of all the circumstances," citing landmark Supreme Court decisions in *Basic* v. *Levinson* and *TSC Industries* v. *Northway*. The SEC commentary further states that there may be situations where, although the instructions to Item 404(a) do not expressly provide that disclosure is not required, the interest of a related person is not a direct or indirect material interest. In that case, information regarding the interest and transaction is not required under Item 404(a).[25]

The SEC declined to except ordinary course transactions with a company (such as ordinary purchases of goods or services provided by a company) from Item 404(a). Instead, the SEC commentary notes that some transactions that should be properly disclosed under Item 404(a) would be excluded by such an exception. The SEC provided an example of employment of immediate family members of officers and directors. However, the SEC noted that:

> [W]hether a transaction which was not material to the company or the other entity involved and which was undertaken in the ordinary course of business of the company and on the same terms that the company offers generally in transactions with persons who are not related persons, are factors that could be taken into consideration when performing the materiality analysis for determining whether disclosure is required the under principle for disclosure [articulated by Item 404(a)].

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[23] This will result in disclosure of indebtedness transactions with regard to all related persons, but unlike the proposed rules, the final rules do not require disclosure of indebtedness transactions with regard to significant shareholders. This is similar to current Item 404(c).

[24] Instruction 1 to Item 404(a).

[25] The SEC commentary accompanying the proposed rules noted that companies may have been "operating under a misconception" as to the application of the current $60,000 threshold. The commentary stated that:

> The current $60,000 threshold is not, and the proposed $120,000 threshold would not be, a bright line materiality standard. The rule calls for, and would 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.

2. Effect on Status of Non-Employee Directors Under Section 16

The SEC commentary states that disclosure of business relationships may now be required where it is not required under the current rules. This is the case because the rules remove the specific standards applicable to business relationships and subject them to the new principles-based $120,000 test.[26] A change in the disclosure of business relationships is significant because directors for whom disclosure is required under Item 404(a) cannot qualify as "non-employee directors" for purposes of Section 16 of the Exchange Act.

We had suggested that the SEC base "non-employee director" status on the basis of stock exchange independence standards. However, the SEC declined to follow this approach. The final rules do partly respond to our concerns by noting that a company may rely, in determining eligibility for "non-employee director" status, on the most recent fiscal year's Item 404(a) disclosure. Where a transaction disclosed in that year's filing was terminated before the director's proposed service as a non-employee director, the transaction will not bar service. On the other hand, the company must believe in good faith that no current or contemplated transaction will require Item 404(a) disclosure.

In light of the guidance included in the final rules regarding the $120,000 test that is described above, it is not clear that the final rules will generally expand the existing disclosure of business relationships. In fact, we expect that certain ordinary course of business transactions with entities related to a director that currently require disclosure under Item 404(b) may not meet the materiality standard of new Item 404(a). Nevertheless, in light of potential consequences of an incorrect judgment in this area, companies will need to make sure that transactions between the company and an entity in which a director has an interest are appropriately tracked.

3. Definitions

As we have discussed, the final rules revise some of the definitions relating to Item 404.

- "Transaction" is defined expansively to include any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships.
- "Related person" has the same list of persons as under the current version of Item 404(a), except that "immediate family" is expanded to include stepchildren, stepparents and *any person* sharing the household of a related person (other than a tenant or employee).
- The related person definition is modified to specify the timeframe for which a determination is made. A director, director nominee, executive officer and their immediate families are considered related persons if the director, director nominee or executive officer served in that capacity *at any*

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[26] The SEC staff has historically taken the view that "if a transaction or relationship is permitted to be excluded pursuant to Item 404(b), disclosure under 404(a) is not required." Item 25, Section J, Item 402 of Regulation S-K, Manual of Publicly Available Telephone Interpretations (July 1997).

time during the last fiscal year.[27] Significant shareholders (and immediate family members) are related persons only for the period during which they are actually significant shareholders.

- "Amount involved" means the dollar value of the amount involved in the transaction or series of similar transactions. The SEC clarified that this determination is made without reference to profit or loss on the transaction. The amount involved would include: the aggregate amount of all periodic payments or installments due on or after the beginning of the previous fiscal year; payments due at the end of the transaction; and, in the case of indebtedness, the largest aggregate principal amount of all indebtedness outstanding at any time since the beginning of the fiscal year and all interest payable on it during the fiscal year.

- In response to comments, the SEC clarified that "participant" is intended to encompass situations where the company benefits from a transaction but is not a contractual party to the transaction.

4. Exceptions

The final rules continue some of the current exceptions, with some revisions:

- Item 404(a) excludes (1) director and executive officer compensation reported pursuant to Item 402 and compensation paid to an executive officer who is not an immediate family member of another related person if the compensation was approved or recommended by the company's compensation committee (or group of independent directors performing that function) as well as (2) compensation of directors reported pursuant to Item 402.[28]

- For indebtedness in which the lender is a bank, thrift or broker-dealer extending credit under Federal Reserve Regulation T and the loans are not disclosed as nonaccrual, past due, restructured or potential problems, Item 404(a) disclosure may consist of a statement that the loans were made in the ordinary course of business and on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable loans to unaffiliated customers, and did not involve more than normal collectibility risk or present other unfavorable features.

- Item 404(a) continues to exclude indebtedness constituting amounts due from the related person for purchases of goods and services subject to usual trade terms, for ordinary business travel and expense payments and for other ordinary course transactions.

- Item 404(a) continues to exclude transactions in which a related person has an indirect interest that arises only from (1) his or her position as a director of another entity and/or ownership of an equity interest in a non-partnership entity in which all related persons have less than a 10% interest or (2) his or her position as a limited partner (but not general partner) in a partnership in which all related persons have less than a 10% interest.

- Unlike the proposal, Item 404(a) continues to exclude transactions where the rates or charges involved are determined by competitive bids or that involve the rendering of services as a common or contract carrier, or public utility, at rates or charges fixed in conformity with law or governmental authority.

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[27] Currently, disclosure under Item 404 is not required for any portion of the relevant period that the person was not a director, nominee or executive officer. *See* Note C to Schedule 14A.

[28] The final rules require that transactions between a company and a third party, where the primary purpose of the transaction is to compensate a named executive officer, must be disclosed pursuant to Item 402 even if they also are disclosed pursuant to Item 404 as a related-party transaction.

- Unlike the proposal, Item 404(a) continues to exclude transactions involving services as a bank depositary of funds, transfer agent, registrar, trustee under a trust indenture, or similar services.
- Item 404(a) also includes a new exception that specifically excludes transactions if the interest of the related person arises solely from the ownership of a class of equity securities of the company and all holders of that class of equity securities of the company received the same benefit on a pro rata basis.

B. APPROVAL OF RELATED-PARTY TRANSACTIONS

Item 404(b) requires the disclosure of a company's policies and procedures for the review, approval or ratification of related-party transactions. The disclosure requires a description of the material features of these policies and procedures, which may include the types of covered transactions, the standards to be applied, the persons responsible for applying the policies and procedures, whether the policies and procedures are in writing, and, if not, how such policies and procedures are evidenced. Disclosure is specifically required of any transaction which is disclosed pursuant to Item 404(a) but did not require review under the company's policies and procedures (or was not so reviewed because the policies and procedures were not followed).[29]

C. PROMOTERS

In the case of filings on Form S-1 and initial filings under the Exchange Act, the final rules require a company to disclose the identity of its "promoters" and its transactions with promoters if the company had a promoter at any time during the last five fiscal years. This changes current requirements, which allow omission of disclosure if the applicable company was organized more than five years before the disclosure.

V. CORPORATE GOVERNANCE DISCLOSURE

The final rules consolidate and build on existing disclosure requirements regarding director independence and corporate governance. This disclosure is contained in new Item 407 of Regulation S-K.[30]

A. DIRECTOR INDEPENDENCE

The proposal would have required the disclosure of any transaction, relationship or arrangement with a director that was considered by the board of directors in determining that a director was independent but that was not disclosed under Item 404(a). This would have resulted in the disclosure of numerous immaterial relationships and limited any benefit of establishing categorical standards under the NYSE and

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[29] No disclosure is required regarding a transaction that occurred at a time before the related person had the relationship that would trigger disclosure under Item 404(a), if the transaction did not continue after the related person had that relationship.

[30] The disclosure to be consolidated in Item 407 is currently found in Items 306, 401(h), (i) and (j), 402(j) and 404(b) of Regulation S-K and Item 7 of Schedule 14A.

NASD listing requirements. The final rules depart significantly from the proposal and require disclosure only of the *type* of transactions, relationships or arrangements considered but not otherwise disclosed under Item 404(a). This disclosure is much more likely to be consistent with the use of categorical standards.

Some of the other significant items the final rules require are:

- Identification of independent directors.[31] This disclosure is required even if the director resigns or does not stand for reelection.
- Identification of any non-independent members of the compensation, nominating and audit committees.
- Disclosure that the applicable definitions of "independence" are posted on the company's web site or, alternatively, that the definitions are included in the proxy statement at least once every three years.

B. COMPENSATION PROCESS

The final rules also require disclosure regarding compensation committees that is similar to the disclosure currently required for audit and nominating committees. In particular, companies will need to identify by name any compensation consultant that played a role in determining or recommending the amount or form of executive or director compensation, as well as stating whether the consultant was engaged by the compensation committee or another person, and describing the nature and scope of the assignment and the material elements of the instructions or directions given. Unlike the proposal, the final rules do not require companies to identify the executive officers whom the consultant contacted in carrying out its assignment. Other required disclosures include the scope of authority of the compensation committee and the extent to which the compensation committee may delegate any authority and to whom.

Although this disclosure appears similar to the CD&A, the SEC notes that the disclosure required by this item focuses on the company's corporate governance structure. In contrast, the CD&A is intended to focus on compensation policies and objectives and to put the quantitative disclosure in context.

VI. BENEFICIAL OWNERSHIP DISCLOSURE

The final rules require a footnote to the beneficial ownership table that discloses the number of shares pledged as security by named executive officers, directors and director nominees and directors and officers as a group. The final rules reiterated that those pledges could have the potential to influence management's performance and decisions. This disclosure requirement does not apply to shares owned

[31] The relevant determination of independence is to be made in reference to the applicable listing standards (including exemptions) or, if the company is not listed, the listing standards of any national securities exchange or inter-dealer quotation system.

by greater than 5% shareholders (other than pledges that may result in a change in control, as currently required). The final rules also require disclosure of beneficial ownership of directors' qualifying shares.

VII. NON-U.S. ISSUERS

The final rules have only limited effect on non-U.S. SEC-reporting issuers, other than to liberalize the circumstances under which these non-U.S. issuers may refrain from filing employment agreements or compensation standards.

A. EXECUTIVE AND DIRECTOR COMPENSATION DISCLOSURE

The final rules generally do not change the current rules regarding executive compensation disclosure for non-U.S. SEC-reporting issuers. They continue to be required only to provide the information required by Items 6.B and 6.E.2 of Form 20-F with more detailed information if otherwise made publicly available.

B. EXHIBITS TO FORM 20-F

The final rules no longer require non-U.S. SEC-reporting issuers to file as an exhibit to Form 20-F any management contracts or compensatory plans, even if the issuer provides compensation information on an individual basis, so long as public filing of these contracts or plans is not required in the applicable home country and is not otherwise publicly disclosed by the issuer.

C. CORPORATE GOVERNANCE AND RELATED-PARTY TRANSACTIONS

With respect to related-party transactions, a non-U.S. SEC-reporting issuer currently must provide only the information required by Item 7.B of Form 20-F. The final rules continue to require this and require additional detailed disclosure only to the extent otherwise made publicly available or required to be disclosed by the issuer's home jurisdiction or a market on which its securities are listed or traded.

VIII. REGISTERED INVESTMENT COMPANIES

The final rules reorganize but do not change the disclosure currently required by Item 7 of Schedule 14A in respect of nominating and audit committees, board meetings, the nominating process and shareholder communications by instead requiring it under Item 22(b) of Schedule 14A. They also revise Item 22(b) to include disclosure regarding nominating and audit committee independence similar to that required by the Item 407(a) of Regulation S-K described in Section V on pages 30-31. Finally, the final rules raise from $60,000 to $120,000 the threshold for disclosure of certain interests, transactions and relationships of each disinterested director or nominee of an investment company.

IX. ADDITIONAL CHANGES

A. PLAIN ENGLISH

The final rules require information to be disclosed in the SEC's plain English format.

B. TIMING AND TRANSITION RULES

Companies will not be required to "restate" compensation or related party disclosure for prior fiscal years. This means, for example, that only the most recent fiscal year will be included in the revised summary compensation table once the rules become effective. This results in a phased-in implementation over a three-year period. During this period, companies will not be required to present prior years' compensation disclosure or Item 404(a) disclosure under the former rules.

The final rules become effective in the following manner:

- For proxy statements, compliance is required for proxy statements that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006 (for registered investment companies, compliance is required for any proxy statement filed on or after December 15, 2006).
- For Forms 8-K, compliance is required for triggering events that occur 60 days or more following publication of the rules in the *Federal Register.*
- For Forms 10-K and 10-KSB, compliance is required for fiscal years ending on or after December 15, 2006.
- For Securities Act and Investment Company Act registration statements (including post-effective amendments) and Exchange Act registration statements, compliance is required for those statements that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

Finally, the interpretive guidance regarding perquisites, unlike the final rules generally, are applicable no matter when a relevant document is filed.

* * *

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is an international law firm serving clients through a network of 12 offices located in leading financial centers in Asia, Australia, Europe and the United States. Our clients include major industrial and commercial companies, financial institutions, governments, educational, charitable and cultural institutions, and individuals, estates and trusts.

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Annex

Example of Compensation Disclosure

I. Compensation Discussion & Analysis

General narrative disclosure describing the objectives of compensation programs, what the compensation program is designed to reward, each element of compensation and why the company chooses to pay each, how the company determines what amount of each element to pay and how the company's determinations fit into its overall compensation decisions.

II. Recent Fiscal Year Compensation

A. Summary Compensation Table

Name and Principal Position (a)	Year (b)	Salary ($) (c)	Bonus ($) (d)	Stock Awards ($) (e)	Option Awards ($) (f)	Non-Equity Incentive Plan Compen-sation ($) (g)	Change in Pension Value and Nonqualified Deferred Compen-sation Earnings ($) (h)	All Other Compen-sation ($) (i)	Total ($) (j)
Principal Executive Officer	_____ _____ _____								
Principal Financial Officer	_____ _____ _____								
A	_____ _____ _____								
B	_____ _____ _____								
C	_____ _____ _____								

B. Grants of Plan-Based Awards

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards ($/sh)
		Thresh-old ($)	Target ($)	Maxi-mum ($)	Thresh-old (#)	Target (#)	Maxi-mum (#)			
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)
Principal Executive Officer										
Principal Financial Officer										
A										
B										
C										

C. Narrative Disclosure

Narrative disclosure describing any material factors necessary to understand the tables above, including the material terms of each named executive officer's employment agreement, a description of any repricing or modification of equity awards over the year, the material terms of any plan-based awards and an explanation of the amount of salary and bonus in proportion to total compensation.

III. Equity Holdings and Value Realization

A. Outstanding Equity Awards at Fiscal Year-End

	Option Awards					Stock Awards			
Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexer-cised Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Principal Executive Officer									
Principal Financial Officer									
A									
B									
C									

B. Option Exercises and Stock Vested

	Option Awards		Stock Awards	
Name (a)	Number of Shares Acquired on Exercise (#) (b)	Value Realized on Exercise ($) (c)	Number of Shares Acquired on Vesting (#) (d)	Value Realized on Vesting ($) (e)
Principal Executive Officer				
Principal Financial Officer				
A				
B				
C				

IV. Post-Employment Benefits

A. Pension Benefits

Name (a)	Plan Name (b)	Number of Years Credited Service (#) (c)	Present Value of Accumulated Benefit ($) (d)	Payments During Last Fiscal Year ($) (e)
Principal Executive Officer				
Principal Financial Officer				
A				
B				
C				

B. Nonqualified Deferred Compensation

Name (a)	Executive Contributions in last FY ($) (b)	Registrant Contributions in last FY ($) (c)	Aggregate Earnings in Last FY ($) (d)	Aggregate Withdrawals/ Distributions ($) (e)	Aggregate Balance at Last FYE ($) (f)
Principal Executive Officer					
Principal Financial					

Name (a)	Executive Contributions in last FY ($) (b)	Registrant Contributions in last FY ($) (c)	Aggregate Earnings in Last FY ($) (d)	Aggregate Withdrawals/ Distributions ($) (e)	Aggregate Balance at Last FYE ($) (f)
Officer					
A					
B					
C					

C. Potential Payments on Termination or Change in Control

Narrative and quantitative disclosure of termination and change-in-control arrangements with named executive officers, including quantification of estimated payments and benefits and an explanation of the circumstances giving rise to payments, factors used to determine the appropriate amount of payments and benefits and the material conditions to the named executive officers' receipt of such payments.

V. Director Compensation

A. Director Compensation

Name (a)	Fees Earned or Paid in Cash ($) (c)	Stock Awards ($) (d)	Option Awards ($) (d)	Non-Equity Incentive Plan Compensation ($) (e)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) (f)	All Other Compensation ($) (g)	Total ($) (h)
A							
B							
C							
D							
E							

B. Narrative Disclosure

Narrative disclosure of any material factors necessary to understand the director compensation disclosed in the table, including a description of standard arrangements and whether any director has a different arrangement.