

UPDATE: SEC PUBLISHES FINAL EXECUTIVE COMPENSATION DISCLOSURE RULES

As reported in an earlier Client Alert¹, on July 26, 2006, the Securities and Exchange Commission adopted significant amendments to its disclosure requirements for executive officer and director compensation, related party transactions and director independence and other corporate governance matters. These final rules contain some noteworthy modifications from the amendments originally proposed in March of this year.² On August 11, 2006, the SEC published its final rules³, and on September 8, 2006 those final rules were published in the Federal Register⁴ to be effective as of November 7, 2006. The final rules, which are summarized below, can be broken down into three categories: (a) executive officer and director compensation (whether currently paid or deferred) and earnings under benefit plans; (b) equity-related holdings connected to performance that can provide future gains (as well as gains realized through awards obtained in the past fiscal year); and (c) retirement/ post-employment compensation and benefits.

These final rules will be effective for proxy statements filed for fiscal years ending on or after December 15, 2006, which means they will be applicable to nearly all annual meeting proxy statements filed during the 2007 proxy season.

Executive Officer and Director Compensation Disclosure

The bulk of the final rules relates to disclosures of executive officer and director compensation. The SEC is requiring issuers to provide a summary and analysis of the goals and objectives behind compensation for executives and the factors considered in making compensation decisions.

The most noteworthy changes to the required disclosures of executive officer and director compensation under the final rules are:

➤ *Compensation Discussion and Analysis.* The final rules require a new Compensation Discussion and Analysis section that discusses the objectives and the implementation of executive compensation programs. The Compensation Discussion and Analysis must be filed (rather than furnished) with the SEC, and therefore will be covered by the certification of the company's principal executive officer and principal financial officer that must be filed under the Sarbanes-Oxley Act of 2002 with each Form 10-K Annual Report. In addition, the proxy statement must include a Compensation Committee Report stating whether

¹ See Client Alert entitled "Update: SEC Approves Final Executive Compensation Disclosure Rules" dated August 2, 2006.

² See Client Alert entitled "SEC Proposes Sweeping Amendments to Compensation, Related Party and Corporate Governance Disclosure Requirements in Proxy Statements" dated March 1, 2006.

³ See Release No. 33-8732 entitled "Executive Compensation and Related Person Disclosure", which is available on the SEC's website at <http://www.sec.gov/rules/final/2006/33-8732.pdf>.

⁴ See The Federal Register Volume 71, No. 174, which is available at <http://www.sec.gov/rules/final/2006/33-8732afr.pdf>.

the compensation committee (i) reviewed and discussed the Compensation Discussion and Analysis with management and (ii) based on this review and discussion, recommended that the analysis be included in the company's annual public filings. The Compensation Discussion and Analysis serves as an overview of the material elements of a company's compensation policies and programs and focuses on such matters as:

- company policies for allocating between long-term and currently paid compensation and between cash and non-cash compensation;
- the specific items of corporate performance taken into account in setting compensation policies and making compensation decisions;⁵
- how specific elements of compensation are structured to reflect these items;
- the impact of accounting and tax treatments;
- whether the company has security ownership requirements or guidelines (including policies on hedging);
- whether the company engages in benchmarking, including the benchmarks and component companies;
- the role of executive officers in the compensation process;
- issuer policies and decisions regarding the adjustment or recovery of payments if the performance measures upon which such payments were based are adjusted in some manner that would reduce the payment size; and
- the basis for selecting the triggering events which trigger payment with respect to post-termination agreements.

The final two items were not included in the proposed rules, but were added by the SEC in response to comments on the initial proposed rules.

The Compensation Discussion and Analysis also includes more narrative disclosure with respect to option grants to executives. Companies are required to provide information regarding the reasons a company selects particular grant dates for awards, methods a company uses to select the terms of awards and how timing is determined (including whether a company has a plan in place to coordinate option grants to executives with releases of material non-public information). These disclosure requirements are in response to concerns raised by numerous recently announced investigations involving the back-dating of option grants and the granting of options prior to material news announcements, neither of which practices is necessarily illegal in and of itself but which have generated much debate as to how they should be disclosed.

➤ *Covered Officers.* The specific executive officers whose compensation must be disclosed (along with that of the principal executive officer) is modified as follows:

- The principal *financial* officer (including anyone who served in such position at any time during the year) has to be included regardless of whether he or she is among the top five most highly compensated executive officers.
- The three other executive officers to be included are selected on the basis of highest "total compensation", rather than just highest salary and bonus, with the minimum threshold raised to \$100,000.

⁵ In this connection, companies are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors or any other factors or criteria involving confidential, commercial or business information.

- The only compensation element that companies are permitted to ignore for purposes of identifying the three other most highly-compensated executive officers are payments attributed to overseas assignments. Companies are no longer permitted to exclude other types of payments currently excludable on the basis of being “not recurring and unlikely to continue”.

These new rules may add additional burdens on issuers, who will now be required to track a greater number of components of employee compensation which may result in more frequent shifts in the identity of the top three executive officers.

The SEC has not yet finalized its highly-publicized and controversial proposal that the accompanying narrative include the total compensation and job positions of a company’s three most highly compensated employees (regardless of whether they were executive officers) whose compensation during the last fiscal year was greater than that of any of the named executive officers listed in the table (the so-called “Katie Couric rule”). The SEC has asked for comments as to whether this proposal should apply (i) only apply to employees who have responsibility for significant policy decisions within a company or a significant subsidiary, principal business unit, division or function and/or (ii) only to large filers.

➤ *Summary Compensation Table.* The current Summary Compensation Table is still included in the disclosure and remains the primary source for disclosure of executive compensation subject, however, to the following significant changes:

- The addition of a “Total Compensation” column representing the aggregate dollar value of the various forms of compensation from the other columns.
- A requirement that all deferrals of salary and bonus be described in a footnote.
- Required disclosure of the dollar value of all stock and option awards (rather than the number of securities as under the current rule), with such dollar value being the “grant date fair value” as determined in accordance with FASB No. 123R.
- Required disclosure of the dollar value of any compensation earned during the year under non-stock incentive plan awards upon the satisfaction of the relevant specified performance criteria (whether or not payment is actually made to the executive at that time). This column replaces the Long-Term Incentive Plan Payouts column under the current rules.
- The addition of a new column requiring disclosure of the aggregate increase in actuarial value of defined benefit and actuarial plans accrued during the year and above-market or preferential earnings on non-qualified deferred compensation.
- Inclusion of both annual and long-term compensation in a single “All Other Compensation” column⁶, which will reflect such items paid to or earned by the named executive officers as:
 - perquisites and other personnel benefits if they equal, in the case of any named executive officer, at least \$10,000 in the aggregate, with specific footnote disclosure of any perquisite valued at the greater of \$25,000 or

⁶ Each item that exceeds \$10,000 is required to be separately identified and quantified in a footnote.

10% of total perquisites (under the current rules disclosure is required only if the aggregate value of the perquisites and personal benefits are at least \$50,000 in value or 10% of all perquisites paid to the named executive officer);

- amounts paid or accrued in connection with any termination of employment or change in control;
- company contributions or other allocations under defined contribution plans;
- premiums paid by the company for life insurance;
- tax “gross up” payments; and
- discounted purchases of company securities not generally available to security holders or company employees.

While these changes to the Summary Compensation Table are intended to be useful to investors, there is a risk that the total compensation column will not correspond to the actual amount received by the top executive officers since certain amounts included in the formulation are subject to forfeiture and/or could become less valuable (such as those tied to performance) over time.

➤ *Perquisites and Personal Benefits.* The subject of perquisites and personal benefits has received renewed attention from activist investors and corporate governance advocates who have become concerned that significant portions of executive compensation may be hidden through perquisites unknown to the public. The SEC continues to resist providing a specific definition of perquisites, but has provided guidance as to how issuers should analyze whether an item must be disclosed as a perquisite. The SEC proposes a two part approach:

- First, the company should consider whether an item is “integrally and directly related to the performance of the executive’s duties”. The concept of “integrally and directly related” to job performance is intended to be a narrow one, covering such items as:
 - office space at a company business location (even if larger than those used by other employees);
 - a reserved parking space that may be closer than those of other employees but not otherwise preferential;
 - additional clerical or secretarial services “devoted to company matters”;
 - travel to and from business meetings and other business travel, including security provided on such travel; and
 - business entertainment and itemized expense accounts used *only* for business purposes.

If there is an integral and direct connection of the expense to the executive’s job performance, the second step must be considered. If not, the item is a perquisite.

- Second, the company should consider whether an item confers “a direct or indirect benefit that has a personal aspect”. An item may have a personal aspect even if it is a benefit provided for a business reason, *unless the benefit*

is provided on a non-discriminatory basis to all employees. Benefits with a personal aspect include:

- use of company-provided vehicles, aircraft, yachts or other watercraft for personal purposes, even if required as a security matter;
- personal use of other property owned or leased by the company;
- commuter transportation services;
- additional clerical or secretarial services used for personal matters;
- investment management services and personal financial and tax advice;
- club memberships not used exclusively for business entertainment purposes;
- housing and other living expenses (including relocation assistance);
- discounts on the company's products or services not generally available to employees on a non-discriminatory basis; and
- security provided at a personal residence or during personal travel.

If there is a personal aspect to the benefit conferred, the item is a perquisite.

The final rules also state that a company's determination that an expense is an "ordinary" or "necessary" business expense for tax or other purposes is *not* determinative of whether or not it should be disclosed in a proxy statement. Also, perquisites and personal benefits are to be valued on the basis of on their "aggregate incremental cost to the company", without reference to valuations for federal income tax purposes.

➤ *Additional Executive Compensation Tables.* The final rules add a new table to supplement the Summary Compensation Table and change the other tables previously required as follows:

- The Grants of Plan Based Awards Table provides details on the material terms of incentive plan awards to named executive officers. Although the proposed rules initially called for two supplemental tables, the SEC condensed the tables into one. Disclosure is to be done on a grant-by-grant basis. The table includes the number of shares or units underlying the awards made during the preceding year, grant terms and the amount of estimated future payments, the closing market price of the underlying stock on the grant date (if it is greater than the exercise price of the award) and the date the award was granted by the compensation committee or board of directors (if different from the grant date). If the exercise price of an option is not the grant date closing market price, a description of the methodology for determining the expense price must be included.
- The Outstanding Equity Awards at Fiscal-Year End Table is the primary manner of disclosure of outstanding equity interests. This new table shows outstanding awards to the named executive officers representing potential amounts which may be received in the future, and includes information regarding the amount of securities underlying exercisable and unexercisable options, exercise prices and expiration dates for each outstanding option.

Disclosure is to be presented on a grant-by-grant basis (as opposed to on an aggregate basis as initially proposed).

- The new Option Exercises and Stock Vested Table shows amounts realized by the named executive officers on equity compensation during the past fiscal year. The SEC deleted the proposed requirement to repeat the grant date value previously included in the Summary Compensation Table.
- The new Pension Benefits Table discloses the actuarial present value of each named executive officer's accumulated benefit under each pension plan. Disclosure of any pension benefits paid in the preceding year must be included as well, which is a change from the proposed rules.
- The new Nonqualified Deferred Compensation Table discloses executive contributions, company contributions, withdrawals, all earnings for the year and year-end balances under nonqualified deferred compensation plans.

Each of these tables must be accompanied by narrative disclosure regarding payments or benefits to the named executive officers at, following or in connection with any termination of employment, change in responsibilities or change in control of a company. Issuers must describe the specific circumstances that would trigger the payment of severance or other benefits, and quantify those payments and benefits that would be made to named executive officers in the event of a termination of employment or a change in control.

➤ *Director Compensation.* Companies now have to disclose director compensation for the last fiscal year in a Director Compensation Table, accompanied by narrative disclosure. Disclosure is required on an individual director basis. The Director Compensation Table is similar in format to the Summary Compensation Table and will include:

- information only for the last fiscal year;
- perquisites and other personal benefits if they total at least \$10,000 per director;
- earnings on certain deferred compensation;
- tax reimbursement payments;
- company contributions under defined contribution plans;
- discounted purchases of company securities not generally available to security holders or salaried employees;
- increases in the actuarial value of defined benefit and actuarial plans;
- consulting fees;
- costs under programs calling for the company to make charitable contributions in a director's name upon a designated event such as retirement or death; and
- premiums paid by the company for life insurance.

Beneficial Ownership Disclosure

The SEC added a footnote requirement to the beneficial ownership table required by Item 403 of Regulations S-K setting forth the number of shares *pledged* by named executive officers, directors, director nominees and directors and officers as a group. This new requirement does

not extend to 5% shareholders, unless a pledge by any such shareholder could result in a change of control of the company.

Related Person Transactions, Director Independence and Other Corporate Governance Matters

➤ *Related Person Transactions.* The final rules require disclosure of existing or currently proposed transactions in which:

- the issuer participated;
- the amount involved was at least \$120,000 (increased from \$60,000); and
- a “related person” had or will have a direct or indirect material interest, with certain exceptions.

Unlike the previous rules, the final rules treat indebtedness like all other related party transactions in terms of the persons covered (including significant shareholders and their immediate family members) and required disclosures.

➤ *Approval of Related Party Transactions.* The final rules require disclosure of the policies and procedures established by a company and its board of directors for the review, approval or ratification of any related party transaction that would be reportable under Regulation S-K Item 404(a), including:

- types of transactions covered;
- standards to be applied;
- persons or groups on the board or otherwise responsible for applying the policies and procedures; and
- how such policies and procedures are evidenced (in writing or otherwise).

Disclosure is specifically required if the policies and procedures:

- do not require review, approval or ratification of any transaction that is reportable under Regulation S-K Item 404(a); *or*
- are not followed in any situation in which review, approval or ratification is otherwise required by the policies and procedures.

➤ *Director Independence and Other Corporate Governance Matters.* The final rules consolidate the various director independence and related corporate governance disclosure items into a single item, new Item 407 of Regulation S-K, that includes:

- disclosure as to whether each director and director nominee is considered to be independent;
- identification of any member of the compensation, nominating or audit committee who is not considered to be independent;
- description by specific category of any transactions or arrangements not disclosed as a related person transaction which were considered by the board of directors when determining whether applicable independence standards were satisfied;

- required disclosures relating to audit committee financial experts; and
- compensation committee-related disclosures.

Plain English Disclosure in Proxy Statements

Going forward, most of the information provided in proxy statements has to be prepared using the plain English principles that previously only applied to registration statements.

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Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below. As always, we are available to assist you in developing and implementing practices and procedures in order to assure compliance when the SEC's new executive compensation disclosure requirements become effective.

		<u>Phone</u>	<u>E-Mail</u>
<i>New York</i>	Scott Edelman	212-530-5149	sedelman@milbank.com
	Roland Hlawaty	212-530-5735	rhlawaty@milbank.com
	Thomas Janson	213-892-4473	tjanson@milbank.com
	Robert Reder	212-530-5680	rreder@milbank.com
	Douglas Tanner	212-530-5505	dtanner@milbank.com
<i>Los Angeles</i>	Ken Baronsky	213-892-4333	kbaronsky@milbank.com
	Michael Diamond	213-892-4500	mdiamond@milbank.com
<i>Hong Kong</i>	Anthony Root	852-2971-4842	aroot@milbank.com
	Edward Sun	852-2971-4841	esun@milbank.com

In addition, if you would like copies of our other Client Alerts or the SEC's release describing its final rules governing executive compensation and related party disclosure, please contact any of the attorneys listed above. You can also obtain this and our other Client Alerts by visiting our website at <http://www.milbank.com> and choosing the "Current Topics" link.

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Worldwide Offices

New York

One Chase Manhattan Plaza
New York, NY 10005-1413
212-530-5000

Los Angeles

601 South Figueroa Street, 30th Floor
Los Angeles, CA 90017
213-892-4000

Washington, D.C.

International Square Building
1850 K Street, N.W., Suite 1100
Washington, D.C. 20006
202-835-7500

London

Dashwood House
69 Old Broad Street
London EC2M 1QS England
44-207-448-3000

Frankfurt

Taunusanlage 15
60325 Frankfurt am Main
Germany
49-69-71914-3400

Munich

Maximilianstrasse 15
(Maximilianhoefer)
80539 Munich, Germany
49-89-25559-3600

Tokyo

Fokoku Seimei Building
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
813-3504-1050

Hong Kong

3007 Alexandra House
18 Chater Road
Central, Hong Kong
852-2971-4888

Singapore

30 Raffles Place
#14-00 Caltex House
Singapore 048622
65-6428-2400

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