



## SEC ADOPTS CHANGES TO EXECUTIVE COMPENSATION DISCLOSURE RULES

### NEW INTERIM FINAL RULES AFFECT STOCK-BASED COMPENSATION DISCLOSURE FOR UPCOMING PROXY SEASON

On December 22, 2006, the Securities and Exchange Commission (the "SEC") adopted interim final rules amending certain provisions of the executive compensation disclosure rules issued in August 2006 (the "Amendments").<sup>1</sup> The SEC's revisions, which were adopted without a notice and comment period, are effective immediately upon publication in the Federal Register and will be effective for the 2007 proxy season.

The Amendments significantly affect the disclosure of all equity-based awards in the Summary Compensation Table and Director Compensation Table. Additionally, the Grant of Plan-Based Awards Table will also need to be revised and updated to conform to the Amendments. The disclosure of equity-based awards will now be based on the methodology of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ("FAS 123R") and will thus more closely track how equity-based awards are reflected and recognized in the financial statements.

### SIGNIFICANT CHANGES

The key provisions of the Amendments will require changes to certain tables and footnotes and the Compensation Discussion and Analysis ("CD&A").

#### **Summary Compensation Table:**

- The Stock Awards and Option Awards columns will need to be revised to reflect the compensation cost of a equity-based award over the requisite service period, in accordance with FAS 123R, rather than indicating the cost of the grant in full in the year of the grant (as the rules originally required). The cost must include both the compensation expense listed in the financial statements and any amounts that have been capitalized for the fiscal year. This change may materially affect total compensation amounts for the named executive officers.

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- Any salary or bonus forgone by a named executive officer in favor of receiving non-cash compensation will be reported in the Salary or Bonus column, with appropriate footnote disclosure of the receipt of the non-cash compensation and a reference to such disclosure in the Grant of Plan-Based Awards table.
- The compensation cost for an award with a performance-based vesting provision will be disclosed in the Summary Compensation Table only if it is probable that the performance condition will be achieved. Thus, companies will need to estimate, at the time of grant, the portion that may be earned during each vesting period. A company may be required to “reverse” a compensation cost if a portion of the award was deemed likely to be achieved, but is now considered improbable.
- The treatment of forfeited awards has changed. Contrary to FAS 123R, estimates of forfeitures related to service-based vesting conditions will be excluded from calculating the awards disclosed in the Summary Compensation Table. Actual forfeitures of awards by a named executive officer during a period should be disclosed in the Summary Compensation Table, with the amount of compensation cost previously disclosed deducted

in the period in which the award was forfeited.

#### ***Grant of Plan-Based Awards Table***

- A new column has been added to show the grant date fair value of each equity-based award, as determined under FAS 123R. This amount was previously included in the Summary Compensation Table under the rules as originally adopted.
- The Grant of Plan-Based Awards table must now include disclosure of repriced or materially modified options, SARs and similar instruments (on a per grant basis), and specifically must disclose the incremental fair value as computed under FAS 123R as of the repricing or modification date. Certain events, such as a repricing based on a pre-existing formula in the plan, or a repricing or an adjustment affecting all holders of the underlying securities, are excluded. Additional disclosure regarding a repricing event may be provided in the narrative portion of the CD&A.

#### ***Director Compensation Table***

- Generally, the Amendments conform the Director Compensation Table to the changes described above with respect to the Summary Compensation Table.
- Footnote disclosure of the full grant date fair value of each equity award

is required to be included in the Director Compensation Table.

Finally, the Amendments require that companies use the FAS 123R “modified prospective transition method” in determining whether certain awards granted prior to 2006, including equity awards not yet vested, require disclosure in the Summary Compensation Table for fiscal 2006 and later years.

### **ACTION ITEMS**

#### ***Review Pre-2006 Grants***

Companies will have to look at equity awards in prior years in order to prepare the Summary Compensation Table and Director Compensation Table. If the service period for prior awards extended into 2006, disclosure of the values associated with those awards may be required in the upcoming proxy statement. Companies also should be sensitive to differences between the transition rules under FAS 123R and the method for determining value for use in the compensation table.

#### ***Revise and Update Affected Tables***

As most companies have already started compiling the data necessary to draft and prepare the CD&A for their upcoming proxy, the Summary Compensation Table, Director Compensation Table and Grant of Plan-Based Awards Table must be examined and revised in accordance with the new rules. The finance and accounting department should coordinate with the company's auditors

to ensure that the proper calculations are included in these tables.

## **Review and Update Named Executive Officers**

Although the definition of a “named executive officer” (the named executive officers are comprised of the CEO, CFO and three other executive officers earning the highest total compensation) did not change, the Amendments altered how total stock-based compensation would be calculated. Companies must evaluate whether the named executive officer list prepared for the forthcoming proxy needs to be changed as compared to the individuals that may have been initially listed pursuant to the August 2006 rules.

*If you have any questions, feel free to contact your Arnold & Porter attorney or any of the attorneys listed below.*

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## **Footnote**

<sup>1</sup> See SEC Release No. 33-8765; 34-55009 (Dec. 22, 2006), which is available at <http://www.sec.gov/rules/final/2006/33-8765.pdf>. The December release amends the rules issued in August 2006, which can be found at <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.