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SEC Adopts Rules Covering Executive Compensation Disclosure

On August 11, 2006, the Securities and Exchange Commission (“SEC” or “Commission”) released its new rules on executive compensation and related party transaction disclosure.¹ The new rules will affect disclosure in proxy statements filed on or after December 15, 2006, annual reports on Form 10-K covering fiscal years ending on or after December 15, 2006, and registration statements that are filed on or after December 15, 2006, and, effective November 7, 2006, will also modify the current reporting requirements of Form 8-K concerning compensation arrangements.

Highlights of the new rules include the following:

- Total compensation of named executive officers will be disclosed, in dollars, in a single table.
- The addition of a new Compensation Discussion and Analysis section requiring disclosure of the objectives of a company’s compensation program, the elements used to accomplish the objectives and a discussion of why and how each element is used to achieve the company’s compensation objectives.
- The new Compensation Discussion and Analysis disclosure will be deemed “filed” with the SEC and so will be incorporated by reference in other SEC filings and will be covered by CEO and CFO certifications.²

¹ Release No 33-8732, *replaced by* Release Nos. 33-8732A; 34-54302A; IC-27444A; FILE NO. S7-03-06 RIN 3235-AI80 (August 29, 2006) [71 FR 53158] *available at* <http://www.sec.gov/rules/final/2006/33-8732a.pdf> (the “Adopting Release”). *See also* Securities Exchange Act of 1934, Press Release, “SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters,” *available at* <http://www.sec.gov/news/press/2006/2006-123.htm> (Jul. 26, 2006). The open meeting of the SEC at which the final rules were discussed is archived at <http://www.connectlive.com/events/secopenmeetings/sec-072606-archive.ram>.

² Issuers should review their SOX information-gathering procedures and modify them, if necessary, to assure they cover the information required in the new Compensation Discussion and Analysis.

- Disclosure, in a table, of estimated amounts of payments or other benefits which may become payable upon a change in control or termination of employment.
- Total compensation of directors, including perquisites, will be disclosed, in dollars, in a table.
- Threshold for disclosing perquisites lowered to \$10,000; more detailed disclosure required.
- More detailed disclosure required of corporate governance matters, such as director independence and how independence determinations are made.
- Threshold for related party transactions increased to \$120,000; principles-based approach adopted; disclosure of company policies and procedures for entering into related party transactions required.
- Modification of Form 8-K; disclosure of changes in management compensation narrowed to focus on those changes which are “unquestionably or presumptively material.”³ Disclosure will be required of the adoption, amendment or modification of material compensatory plans, contracts or arrangements in which principal executive officers, principal financial officers or named executive officers participate, as well as of the termination of employment of any such officer or other specified officer.
- The performance graph is retained (originally proposed to be deleted).
- The proposal to require disclosure of compensation for up to three other most highly paid employees is dropped from final rules and re-proposed for comment.

The Commission purports to take a “principles-based approach” with respect to many of the rules that have been adopted. In doing so, they have eliminated some of the more technical instructions to the compensation disclosure, although in other places they have added additional bright line tests on subjects which they viewed as important.

A summary discussion of the new rules follows.

I. Executive and Director Compensation

The final rules modify the currently required disclosure concerning compensation to elicit clearer and more complete disclosure with respect to the five “named executive officers” (to be defined as

³ These new Form 8-K requirements will be effective for triggering events occurring on and after November 7, 2006. See discussion in Section VI below.

the principal executive officer, the principal financial officer and the three other highest paid executive officers⁴ whose total compensation exceeds \$100,000⁵) and each of the directors.⁶

A. New Items 402(b) and 407(e)(5): Compensation Discussion and Analysis and Compensation Committee Report⁷

1. Compensation Discussion and Analysis

Under the new rules, the executive compensation disclosure section will begin with a Compensation Discussion and Analysis, an overview which must answer general questions concerning the company's executive compensation policies and decisions, such as:

- What are the objectives of the company's compensation programs?
- What are the compensation elements used to accomplish these objectives?
- For each element, why is it used, how does the company determine the amount (providing a formula if any exists), and how does that element fit into the company's overall compensation objectives?

The instructions to Item 402(b) state that the purpose of this discussion is to "provide to investors material information that is necessary to an understanding of the registrant's compensation policies and decisions regarding the named executive officers" and that companies should "focus on the material principles underlying the registrant's executive compensation policies and decisions. . . ." This new

⁴ "The term 'executive officer,' when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy-making functions for the registrant." Securities Act Rule 405; Exchange Act Rule 3b-7. Therefore, as was formerly the case, a named executive officer may be an executive officer of a subsidiary or an employee of a subsidiary who performs such policy making functions for the registrant. This point is clarified in the context of the new executive compensation disclosure rules in Instruction 2 to new Item 402(a)(3).

⁵ For the purposes of this calculation, total compensation will exclude the increase in pension values and above-market earnings on non-qualified deferred compensation.

⁶ A proposal to require disclosure of the total compensation of up to three additional unnamed employees and a description of their positions with the company included in proposed rule, Executive Compensation and Related Party Disclosure, Release No. 33-8655 (Jan. 27, 2006) [71 FR 6542] (the "Proposing Release"), was not adopted, and has been re-proposed in a new SEC release. See Executive Compensation and Related Party Disclosure, Release No. 33-8735 (Aug. 29, 2006) available at <http://www.sec.gov/rules/proposed/2006/33-8735.pdf>.

⁷ References to Items are to Items of Regulation S-K.

section replaces the substantive disclosure made pursuant the current Compensation Committee Report (Item 402(k)).

2. New Compensation Committee Report

A new Compensation Committee Report has been added under Item 407(e)(5) to supplement the substantive disclosure pursuant to Item 402(b) with procedural disclosure concerning the actions of the board's compensation committee (or committee performing the same function, possibly the full board). Under Item 407(e)(5), the compensation committee must state whether it has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) with management. It must also state whether, based on this review, the compensation committee recommended to the board of directors that the Compensation Discussion and Analysis be included in the registrant's annual report on Form 10-K, proxy statement on Schedule 14A and/or information statement on Schedule 14C. The name of each member of the company's compensation committee (or whatever committee performs the equivalent functions or, in the absence of any such committee, the entire board of directors) must appear below this disclosure. The Compensation Committee Report will not be deemed "filed" or "soliciting material" and will only be required in filing an annual report on Form 10-K or statements on Schedule 14A or 14C.

3. Compensation Discussion and Analysis Deemed Filed

Unlike the current Compensation Committee Report and the new Compensation Committee Report under Item 407(e)(5), the Compensation Discussion and Analysis need not be made over the name of each member of the company's compensation committee. However, the new Compensation Discussion and Analysis will be deemed to be "filed" with the SEC, and not simply "furnished" as the Compensation Committee Report will be. Therefore, insofar as such disclosure is included in, or incorporated by reference into, filings under the Securities Act of 1933 ("Securities Act") and annual reports under the Securities Exchange Act of 1934 ("Exchange Act"), liability will attach to the Compensation Discussion and Analysis disclosure under these Acts. Furthermore, such disclosure will be covered by the CEO and CFO certifications that are required exhibits to Form 10-K. Financial information included in the Compensation Discussion and Analysis, will be subject to the Regulation S-K limitations on the use of non-GAAP financial disclosures⁸, except that disclosure of target levels based on non-GAAP financial measures will not be subject to Regulation G⁹ (in this case, the company must disclose the method of calculating this measure from the audited financial statements).

⁸ Regulation S-K Item 10(e).

⁹ Regulation G restricts and regulates the use of non-GAAP financial measures in both periodic and other financial reporting. When a company publicly discloses or releases material information that includes a non-GAAP financial measure, Regulation G requires the company to present the most directly comparable financial measure, calculated and presented in accordance with GAAP and provide a quantitative reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure calculated and presented in accordance with GAAP.

4. Disclosure of Target Levels for Incentive Compensation

The new rule preserves the current practice that a company need not disclose target levels with respect to specific performance-related factors, or any factors involving confidential commercial or business information, the disclosure of which would have an adverse effect on the company. In making this determination, companies should use the same standard applicable to requests for confidential treatment under Securities Act Rule 406 (17 C.F.R. 230.406) and Exchange Act Rule 24b-2, each of which relies upon Exemption 4 of the Freedom of Information Act (5 U.S.C. § 502(b)(4)).¹⁰ If such a determination is made and the information in question is therefore not disclosed, the company must provide a discussion of the degree of difficulty of achieving the undisclosed target levels.

B. Executive and Director Compensation Section

Following the Compensation Discussion and Analysis, new Item 402 addresses three categories of executive compensation: 1) compensation over the last three years (paragraphs (a)-(f), plus paragraph (k), addressing director compensation); 2) holdings of equity-related interests received as compensation that are possible sources of future gain and gains realized on these interests (paragraphs (g) and (h)); and 3) retirement and other post-employment compensation and benefits, including benefits conditioned on termination or change of control of the company (paragraphs (i) and (j)). The following sections describing the changes to Item 402 are organized according to these categories.

1. Executive and Director Compensation

New Item 402(c): Summary Compensation Table

The Summary Compensation Table will continue, according to the SEC staff, to be the “principal disclosure vehicle” for disclosing executive compensation. Under the final rule, compensation will be disclosed for each named executive officer in the form of a table with the following column format:

Name and Principal Position (a)	Year (b)	Salary (\$ (c)	Bonus (\$ (d)	Stock Awards (\$ (e)	Option Awards (\$ (f)	Non-Equity Incentive Plan Compensation (\$ (g)	Change in Pension Value and Non-qualified Deferred Compensation Earnings (\$) (h)	All Other Compensation (\$) (i)	Total (\$) (j)
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¹⁰ Exemption 4 under the Freedom of Information Act states that that act’s disclosure requirements for government agencies do not extend to matters that are “trade secrets and commercial or financial information obtained from a person and privileged or confidential.” 5 U.S.C. 502(b)(4).

One row of data will be provided for each named executive officer for each of the last three fiscal years; however, years ending prior to December 15, 2006 do not have to be restated and the information for years prior to the most recent fiscal year will not have to be presented at all.¹¹

For each executive and each year, “Total” compensation, listed in the rightmost column, will be the sum of the values in the other columns. Thus, companies will now be required to disclose the total annual value of compensation for its top executives, including stock and option grants, in one place in their public filings. Any compensation earned in a fiscal year but the payment of which is deferred will be included in the table, and described in a footnote. Such deferred compensation will also generally be included in the table listing all non-qualified deferred compensation plans, required under the new Item 402(h).

The disclosure of all compensation in this table is dollar-valued and new rules require disclosure of the value of grants of options and stock appreciation rights (“SARs”), calculated at grant date fair value, and otherwise calculated in accordance with financial statement reporting requirements (governed by FAS 123R¹²). Repricing or material modification of options or SARs will be disclosed as a new award in this table. A footnote describing any financial assumptions relevant to the values entered in these columns should be included.

All stock awards will be aggregated under a single dollar-valued column, “stock awards,” will also be valued at grant date fair value, and will also be otherwise calculated in accordance with FAS 123R. The definition of “stock” under Item 402(a)(6) includes restricted stock, phantom stock, and “similar instruments that do not have option-like features. . . .” Cash incentive awards not tied to the performance of company stock, disclosed under column (g), will continue to be included in the year when the measure is satisfied and the payment is earned.

Under column (h), a company will be required to disclose (1) the aggregate change in the actuarial present value of the named executive officer’s accumulated benefit under all defined benefit and actuarial pension plans (including supplemental plans) and (2) all preferential earnings on compensation that is deferred on a basis that is not tax-qualified. The latter category includes earnings on nonqualified defined contribution plans and above-market interest (defined as over 120% of the applicable federal long-term rate). The total amount is thus the accumulated benefit on retirement plans between the prior audit’s pension plan measurement date and the most recent audit’s measurement date, excluding market-rate interest and tax-qualified defined contribution plan earnings. Any negative amounts are to be reported in a footnote and not the table itself. We note that because negative amounts are to be reported in a

¹¹ Adopting Release at 196-197.

¹² FAS 123R, adopted in 2004, requires companies to account for the cost of share-based compensation, whether stock or options, on the basis of grant-date fair value. Equity-based awards are thus expensed over the vesting period of the grant. Equity instruments for which a market exist should be valued based on that market or on parameters, such as underlying share price and observed volatility, derived from that market. For instruments that have no observable market, estimates must be made based on comparable companies and instruments.

footnote, a reduction in an executive's pension plan value will not reduce the reported value of his total income.

Under the "All Other Compensation" column, companies will be required to include any compensation that does not fall into other columns, including, for example, perquisites, which must be disclosed unless the aggregate of all such benefits is less than \$10,000. This threshold compares to the present threshold of the lesser of \$50,000 or 10% of the total annual salary and bonus of each named executive officer. Footnote disclosure of the types of perquisites will be required if the threshold is exceeded, and each perquisite that exceeds the greater of \$25,000 or 10% of the total amount of perquisites must be quantified. Each other item reported in this column that exceeds \$10,000 must be identified by type and amount.

The proper method of valuing perquisites will continue to be "aggregate incremental cost to the registrant." A footnote describing the methodology for this valuation is required. Consistent with the current rules, gross-ups or other amounts reimbursed during the fiscal year for the payment of taxes must be separately quantified, even if such amounts are related to a perquisite that is not required to be disclosed.

The release contains a discussion of the SEC staff's recent views on perquisites: notably, an item is not a perquisite if it is "integrally and directly related to the performance of the executive's duties," and is a perquisite if it is not so integrally and directly related and confers a direct or indirect benefit that has a personal aspect, unless it is generally available on a non-discriminatory basis to all employees.¹³ The release lists several examples of items that would require disclosure as perquisites. These include club memberships not used exclusively for business entertainment, personal financial or tax advice, personal travel using company vehicles, personal travel otherwise financed by the company, housing and other living expenses, security provided at a personal residence or during personal travel, commuting expenses, and discounts on the company's products or services that are not generally available to all employees on a non-discriminatory basis.

New Item 402(k): Compensation of Directors

Under the new Item 402(k), a company must disclose compensation for each director in a tabular format similar to the Summary Compensation Table above; the format is the same, with the exception that the directors' table lacks the "bonus" column and only one year of compensation will be disclosed for each director.¹⁴ Thus, as for the named executive officers, for each director, option and stock grants will be disclosed at grant date fair value, perquisites will be disclosed in terms of their aggregate incremental cost to the registrant, and total compensation will be disclosed as the sum of the other columns.

¹³ See Adopting Release at 71-78 for SEC guidance on this topic.

¹⁴ The current rules require only narrative disclosure of the terms of the standard director compensation arrangements and the terms of any other arrangements, including any consulting contracts, under current Item 402(g).

New Item 402(d): Grants of Plan-Based Awards Table

The Summary Compensation Table will be accompanied by a Grants of Plan-Based Awards table, disclosing all performance-based awards whether equity- or non-equity-based. New Item 402(d) includes all awards of stock and stock-based incentive plans, and performance-based option grants. For the purposes of this table, an award is “performance-based” if payment is contingent on either performance conditions or market conditions, as those terms are defined in FAS 123R. Each row entry will represent a grant to a specific named executive officer. The table’s column format is as follows:

Name (a)	Grant Date (b)	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 (#) (i)	All Other Option Awards: Number of Securities Underlying Options (#) (j)	Exer- cise or Base Price of Option Awards (\$/Sh) (k)
		Thresh- old (\$) or (#) (c)	Target (\$) or (#) (d)	Maxi- mum (\$) or (#) (e)	Thresh- old (\$) or (#) (f)	Target (\$) or (#) (g)	Maxi- mum (\$) or (#) (h)			

The grant date reported in column (b) is for equity-based awards. If such grant date is different than the date on which the compensation committee (or whatever committee performs its function, possibly the full board) takes action or is deemed to take action to grant such awards, a separate column will be required between columns (b) and (c), showing such date.

Current Item 402(e), Long-Term Incentive Plan (“LTIP”) Awards table, and Item 402(c), Option/SAR Grants table, will be eliminated; much of the data they contain have been moved to the table above, and the value of equity awards will be disclosed in the Summary Compensation Table. Current Item 402(i), Report on Repricing of Options/SARs, will also be eliminated. Repricing of options and SARs will now be disclosed as an award of options, as described above, for purposes of the Summary Compensation Table. Each such repricing will not be required to be disclosed in Item 402(d).

If the exercise or base price is less than the closing market price of the underlying security on the date of the grant (as determined for financial statement purposes pursuant to FAS 123R), a company must describe the methodology for determining the exercise or base price either by a footnote or accompanying textual narrative.

New Item 402(e): Narrative Disclosure to Summary Compensation Table and Grants of Plan-Based Awards Table

The two tables discussed above will be followed by a “narrative description of any material factors necessary to an understanding of the information” disclosed in the tables. Examples of such factors include:

- The material terms of each named executive officer’s employment agreement or arrangement, whether written or unwritten.
- The material terms of any awards disclosed in the Grants of Plan-Based Awards table, including vesting schedules, performance-based conditions and any other material conditions applicable to the award.
- A description of the repricing or material modification of any outstanding option or other equity-based award.
- An explanation of the amount of salary and bonus in proportion to total compensation.

2. Outstanding Equity Interests Received as Compensation

The new rules create two tables related to named executive officers’ outstanding holdings:

New Item 402(f) and Item 402(g): Outstanding Equity Awards at Fiscal Year-End Table and Option Exercises and Stock Vested Table

New Item 402(f) requires an Outstanding Equity Awards at Fiscal Year-End table, showing each named executive officer’s holdings of unexercised options and SARs, unvested stock and unvested shares or units in incentive plan instruments, with the following column format:

Name (a)	Option Awards					Stock Awards			
	Number of Securities Underlying Unexercised Options (#) Exercisable (b)	Number of Securities Underlying Unexercised Options (#) Unexercisable (c)	Equity Incentive Plan Awards: Number of Securities Underlying Un-earned Options (#) (d)	Option Exercise Price (\$) (e)	Option Expiration Date (f)	Number of Shares or Units of Stock That Have Not Vested (#) (g)	Market Value of Shares or Units of Stock Held That Have Not Vested (\$) (h)	Equity Incentive Plan Awards: Number of Un-earned Shares, Units or Other Rights That Have Not Vested (#) (i)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (\$) (j)

The awards listed in this table are to be listed award by award except where multiple awards have the same exercise price and expiration date. Market values listed in column (h) are to be based on calendar year-end market price. Payouts are to be based on threshold, provided that if the previ-

ous fiscal year's performance is greater than threshold, the disclosure must be based on the next higher performance measure. The table should include options transferred without consideration. The vesting dates of all options, shares of stock and equity incentive plan awards held at fiscal-year end must be disclosed in a footnote. The information required by columns (b) and (c) of new Item 402(f) is at present disclosed in columns (d) and (e) under current Item 402(d).

New Item 402(g) requires an Option Exercises and Stock Vested table, showing amounts realized during the year from these interests, with the following column format:

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

The information required by columns (b) and (c) of new Item 402(g) is currently required under columns (b) and (c) of current Item 402(d); all disclosure in the two tables above related to unvested stock, stock vesting, and unvested incentive plan shares and units is new.

The disclosure requirement of the original grant date fair value of all options exercised and stock vested that was in the proposed rule has not been adopted.

3. Retirement Plans and Other Post-Employment Payments and Benefits

Under the new rules, this area of disclosure will be significantly expanded to include two new tables and an expanded narrative disclosure section on benefits upon termination or change in control.

New Item 402(h) and Item 402(i): Pension Benefits and Nonqualified Deferred Compensation Tables

The new Pension Benefits table under Item 402(h) will list the estimated present value of future payments for each named executive officer, as of the last fiscal year-end, with the following column format:

Name (a)	Plan Name (b)	Number of Years Credited Service (#) (c)	Present Value of Accumulated Benefit (\$) (d)	Payments During Last Fiscal Year (\$) (e)
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A separate row will be provided for each plan that each named executive officer participates in. Benefit plans listed in this table will include tax-qualified defined benefit plans and supplemental employee retirement plans, but exclude tax-qualified defined contribution plans and nonqualified defined contribution plans. The table requires disclosure of the actuarial present value of the named executive officer's accumulated benefit under the plan and the number of years of service credited to the named

executive officer under the plan reported in the table, each computed as of the same pension plan measurement date for financial statement reporting purposes with respect to the audited financial statements for the company's last completed fiscal year. If the number of years credited for this purpose differs from the named executive officer's actual years of service with the company, a footnote is required to disclose this deviation and any resulting augmentation of benefits. Item 402(h) will require additional narrative disclosure of all material factors necessary to an understanding of all plans covered by the table above. The description of valuation method and assumptions can be satisfied by referring to financial statements or Management's Discussion and Analysis.

The new Nonqualified Deferred Compensation table required under Item 402(i) will disclose contributions, earnings, and withdrawals and distributions with respect to these plans during the last fiscal year, and their total balance as of the last fiscal year-end, in a table with the following column format:

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)
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Companies will be required to disclose in a footnote the extent to which contributions to and earnings on these plans are also disclosed as compensation in the Summary Compensation Table. This paragraph will require additional narrative disclosure of any material factors necessary to an understanding of each plan covered by the tabular disclosure. The release gives three examples of such factors:

- “the type(s) of compensation permitted to be deferred, and any limitations (by percentage of compensation or otherwise) on the extent to which deferral is permitted;
- the measures of calculating interest or other plan earnings (including whether such measure(s) are selected by the named executive officer or the company and the frequency and manner in which such selections may be changed), quantifying interest rates and other earnings measures applicable during the company's last fiscal year; and
- material terms with respect to payouts, withdrawals and other distributions.”

The disclosures pursuant to Item 402(h) and Item 402(i) will replace the disclosure required by the current Item 402(f), Defined Benefit or Actuarial Plan Disclosure, which requires tabular disclosure where annual pension compensation is based on some measure of final employment compensation and years of service, and narrative disclosure where pension compensation is not based on final compensation.

New Item 402(j): Potential Payments upon Termination or Change-in-Control

New Item 402(j) will require a description of any arrangement that provides for payments or benefits, including perquisites, on the occurrence of termination, change of responsibility, or change of

control of the company. The current disclosure under Item 402(h), which this Item replaces, requires a description of the terms and conditions of any such payments if the total amount involved exceeds \$100,000, but does not explicitly include perquisites and does not require the valuation of any non-monetary compensation. New Item 402(j) expressly requires narrative disclosure of:

- the specific circumstances that would trigger payments or the provision of other benefits;
- the estimated payments and benefits that would be provided in each covered circumstance, whether payment would or could be in a lump sum, or annual, specifying duration, and by whom any payments would be provided;
- how the appropriate payment and benefit levels are determined under the various triggering circumstances;
- any material conditions applicable to the receipt of payments or benefits, such as non-compete, non-solicitation, non-disparagement, or confidentiality agreements, and the terms of such agreements; and
- any other material factors regarding each such agreement.

Item 402(j) will require a quantification of the value of estimated payments or benefits and a disclosure of material assumptions used to make such a quantification. A company must assume the triggering event occurred on the last business day of its last completed fiscal year, and that the market price of its stock is the closing market price on that date. Estimated amounts, or estimated ranges of amounts, will be considered forward-looking information eligible for the safe harbor provided by Section 21A of the Securities Act and Section 21E of the Exchange Act. Perquisites must be identified and quantified to the same extent applicable to disclosure in the Summary Compensation Table described above.

For any payment or benefit that would result from a triggering event and whose form and amount is fully disclosed pursuant to Item 402 (h) or (i) reference may be made to that disclosure. However, if such payment or benefit would be enhanced or accelerated in connection with any triggering event, such enhancement or acceleration must be disclosed pursuant to Item 402(j).

II. Addition to Beneficial Ownership Disclosure

Item 403(b) will be amended to require footnote disclosure to the beneficial ownership table of the number of shares pledged as security by the named executive officers, directors and director nominees. The SEC's rationale for requiring this disclosure is that shares beneficially owned by these persons that are used as collateral may be subject to material risks or contingencies that do not apply to other shares beneficially owned by these persons. In the SEC's view, these circumstances have the potential to influence management's performance and decisions. As a result, the SEC believes that the existence of these pledges could be material to shareholders.

Because significant shareholders who are not members of management are in a different relationship with other shareholders and have different obligations to them, the new rule does not require disclosure of their pledges pursuant to Item 403(b), other than pledges that may result in a change of control currently required to be disclosed.

III. Modification of Disclosure Requirements for Related Party Transactions and Director Independence

A. Revised Item 404: Transactions with Related Persons

The new rules significantly reorganize the disclosure requirements under Item 404 and expand them to include disclosure of the process by which the board reviews related party transactions. The new rules revise Item 404(a) to utilize a “principles-based” approach, eliminating some of the safe harbors and mandatory non-disclosure categories from the current regulation. Thus, the section on business relationships with entities in which a related party has a significant interest, formerly under Item 404(b), has been eliminated, though many of the transactions pursuant to such relationships will presumably be disclosed under Item 404(a). The current Item 404(c), concerning management’s indebtedness to the company, has been eliminated, and such transactions are now included with other related party transactions in Item 404(a) as well.

For transactions of the requisite size in which a related party has a direct or indirect material interest, new Item 404(a) will continue to require disclosure of the nature of the related party’s interest in the transaction, the amount of the transaction, and the amount of the related party’s interest in the transaction. The materiality of the interest will “continue to be determined on the basis of the significance of the information to investors in light of all the circumstances and the significance of the interest to the person having the interest.” The threshold for disclosure of such transactions will be increased from \$60,000 to \$120,000, and the terms “transaction,” “related person,” and “amount involved” have been defined to “clarify the broad scope of financial transactions and relationships covered by the rule.” Also, disclosure will be required when the company is a “participant,” rather than a “party” as in the current rule.

New Item 404(b) requires disclosure of the policies and procedures established by a company and its board of directors regarding related person transactions. The required disclosure must include a description of the company’s policies and procedures for the review, approval or ratification of transactions with related persons that would be reportable under Item 404(a). The description must include the material features of these policies, and how procedures may vary depending on the particular circumstances. Examples of such features may include, in given cases, among other things:

- the types of transactions that are covered by such policies and procedures, and the standards to be applied pursuant to such policies and procedures;
- the persons or groups of persons on the board of directors or otherwise who are responsible for applying such policies and procedures; and
- whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.

The new rules also require identification of any transactions required to be reported under paragraph (a) of Item 404 where the company’s policies and procedures did not require review, approval, or ratification or where such policies and procedures were not followed.

B. New Item 407: Corporate Governance

The new rules create a new Item 407 dedicated to issues related to corporate governance. This Item both consolidates existing disclosure and requires significant new disclosure related to director independence.

Under Item 407(a), a company is required to identify each director (and, in proxy or information statements relating to the election of directors, each nominee for director) who is independent under the listing requirements applicable to the company (or, if the company is not listed, under a national securities exchange or national securities association definition selected and identified by the company). For each director or nominee identified as independent, the company must also describe, by specific category or type, any relationships, transactions or arrangements considered by the board of directors but not otherwise disclosed pursuant to paragraph (a) of Item 404 (*see* III.A above). This disclosure is designed to be “consistent with recent significant changes to the listing standards of the nation’s principal securities trading markets,” the New York Stock Exchange and Nasdaq. If a company is relying on an exemption from independence requirements of a listed issuer, such as a “controlled company” exemption, it must disclose the exemption relied upon and explain the basis for its conclusion that the exemption is available.

Item 407(b) contains the current disclosure requirements of board member attendance at board meetings and committee meetings and the existence of any standing audit, nominating, and compensation committees (or committees performing similar functions) and their membership, and the company’s policy, if any, with regard to board attendance at the annual shareholders’ meeting.

Item 407(c), Item 407(d), and Item 407(e) require disclosure of the composition of the nominating, audit and compensation committees, respectively. Each of the three paragraphs has separate disclosure requirements related to the independence of these respective committees. The disclosure requirement for compensation committees is new, and requires a narrative description of the company’s processes and procedures for the consideration and determination of executive and director compensation. Paragraph (e) also contains the current disclosure requirements of compensation committee interlocks.

Item 407(e)(5) requires a Compensation Committee Report to be included in statements made under Schedule 14A and 14C as discussed in Section I.A.3. above.

Item 407(f) will continue the current requirement to disclose the processes through which shareholders may communicate with the board, or reasons for not having any such processes.

IV. Small Business Issuers and Foreign Private Issuers

The new rules described above do not apply in their entirety to small business issuers. The new rules include changes to Regulation S-B that are similar in form and substance to the changes to Regulation S-K described above. They include changes to that Regulation’s Items 402 and 404 and the creation of a new Item 407. The substitute requirements are in general less onerous and sometimes differ in their particulars from the new requirements under Regulation S-K.

The new rules will have a negligible effect on the disclosure requirements for foreign private issuers.

V. Performance Graph moved to New Section

Non-small business filers under Regulation S-K will continue to be required to provide a Performance Graph such as is currently provided pursuant to Item 402(l). The description of the Performance Graph is substantially unchanged, but the requirement has been moved to paragraph (e) of Item 201, "Market for common equity and related stockholder matters." The company will be required to submit the Performance Graph along with the company's annual report to shareholders; the Performance Graph is not required to be submitted with any other filing. The Performance Graph will not be deemed "filed" with the Commission or incorporated by reference into any filing under the Securities Act or Exchange Act unless the company specifically requests such treatment or specifically incorporates it by reference.

VI. Form 8-K Modifications for Compensation-Related Events

The new rules amend Form 8-K to require reduced disclosure of employment compensation arrangements under a revised Item 5.02. The SEC noted that since Form 8-K was amended in August 2004, many filings in respect of compensation-related arrangements under current Item 1.01 were not "unquestionably or presumptively material," the standard associated with the expanded Form 8-K disclosure items.

Item 5.02(b) will now require disclosure with respect to the retirement, resignation or termination ("triggering events") of any named executive officer, in addition to the enumerated individuals in the current Item. In addition, the required disclosure under Items 5.02(c) and (d) will be expanded beyond employment agreements to include a brief description of any material plan, contract or arrangement to which a covered officer or director is a party or in which he or she participates that is entered into or materially amended in connection with a triggering event, or any grant or award, or modification thereof, in connection with such event. For the purposes of Item 5.02, the "named executive officers" are those persons for whom disclosure was most recently required in the Summary Compensation Table pursuant to Regulation S-K or Regulation S-B. Employment compensation arrangements with executive officers who are not named executive officers will no longer be required on Form 8-K.

Item 5.02(e) will require a brief description of the adoption or material amendment of, or material grant or award under, any material compensatory plan, contract or arrangement (whether or not written), to which a company's principal executive officer, principal financial officer or a named executive officer is a party or in which he or she participates, whether or not such occurrence is in connection with a triggering event specified in Item 5.02. Instruction 2 to Item 5.02(e) provides that grants or awards and modifications of arrangements do not need to be disclosed if they are materially consistent with previously disclosed terms of the arrangement in question. In addition, the instructions to Form S-3 will be amended to provide that failure to make a timely Item 5.02(e) filing will not trigger loss of a company's eligibility to use that Form.

The new rules also add an Item 5.02(f), which will require that companies disclose amounts of salary and bonus which were not calculable at the time a company's proxy statement was filed. This disclosure will include a new total compensation figure for the named executive officer.

VII. Plain English

The new rules will require that the disclosures required by the new and modified compensation disclosure rules be written in “plain English.”¹⁵

VIII. Transition Rules/Compliance Dates

The SEC has adopted the following compliance dates for the new rules:

- For Forms 10-K and 10-KSB, compliance is required for fiscal years ending on or after December 15, 2006.
- For Form 8-K, compliance is required for triggering events that occur on or after November 7, 2006.
- For proxy and information statements for companies other than registered investment companies, compliance is required for statements that are filed on or after December 15, 2006 and are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.
- For Securities Act registration statements covering registrants other than registered investment companies and all Exchange Act registration statements (including pre-effective and post-effective amendments) compliance is required for statements that are filed on or after December 15, 2006 and are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

The SEC will not require companies to “restate” compensation or related person transaction disclosure for fiscal years for which they previously were required to apply the current rules. Instead, the new Summary Compensation Table and disclosure required by new Item 404(a) will be required only for the most recent fiscal year. This will result in phased-in implementation of the new Summary Compensation Table amendments and new Item 404(a) disclosure over a three-year period for Regulation S-K companies, and a two-year period for Regulation S-B companies.¹⁶

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com;

¹⁵ Rules 13a-20 and 15d-20.

¹⁶ The SEC has issued guidance with respect to compliance with the new rules during the transition period. [Executive Compensation and Related Person Disclosure Transition Questions and Answers](http://www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf), available at <http://www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf>.

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