

A horizontal banner image composed of several rectangular panels. From left to right, the panels show: a pair of scales of justice, a stack of books, a close-up of a hand holding a pen over a document, a computer keyboard, and a gavel. Overlaid on this banner is the text "JONES DAY" in a small, white, sans-serif font, and "COMMENTARY" in a large, bold, white, sans-serif font.

JONES DAY COMMENTARY

EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

NEW EXECUTIVE PAY PROPOSALS: NOW COMES THE SEC'S TURN

Now that the Congress (Sarbanes-Oxley and Code Section 409A), FASB (option expensing), and Treasury (expansive deferred compensation regulations) have all taken their best shots at perceived abuses in executive compensation, the SEC is getting in its punch. Its comprehensive new proposal for disclosure of executive compensation in the proxy statements of U.S. public companies, announced at the SEC's open meeting on January 17, 2006, responds to 14 years of developments in executive compensation since the last major SEC overhaul in 1992. There does not appear to be anything radical or even very surprising in the latest approach—the actual Release promulgating the details is not yet available—but every company will need to make major changes in its proxy statement after adoption of the final rules, which are not expected to be effective for the upcoming 2006 proxy season.

As expected, the new proposed rules will require public companies to disclose and describe certain types of executive pay more completely in their proxy statements. The proposed rules cover issues relating to disclosure not only of executive and director compensation but also related party transactions and certain disclosures required by Form 8-K.

IMMEDIATE IMPACT

Although the new rules are not expected to apply to proxy statements for calendar-year companies in 2006, they will have an immediate impact on all companies. Companies will need to focus on the proposed changes now, because compensation decisions made today will need to be disclosed later under the new regime. Companies will also need to begin tracking the data that will likely be required in

future years. In some cases, disclosure decisions made for this year's proxy statement may even be affected by interpretive guidance included in the proposals. For example, because the proposed rules are expected to codify the SEC's position on perquisites, companies will need to be aware of that guidance when preparing this year's Summary Compensation Table.

THE NEW DISCLOSURES

Some of the more significant new executive pay disclosures are highlighted below.

Total Annual Compensation. The rules, if adopted as proposed, would require companies to report the total annual compensation of their CEO, CFO, and their three other most highly compensated named executive officers, as well as (for the first time) their three other most highly compensated employees if any employees are paid more than the named executive officers. This total annual compensation would appear in a separate column of the Summary Compensation Table in the proxy statement. Other notable items in the revised Summary Compensation Table, which will be part of the total annual compensation figure, include (1) the present value of stock options granted for the year, valued as of the grant date (see below) and (2) the aggregate increase in the actuarial value of pension plans accrued during the year, plus earnings on deferred compensation that are not tax-qualified. This "apples-plus-oranges" approach to total annual compensation is likely to produce some unexpected results. It remains to be seen if these numbers will be useful for comparing executive pay at one company with the pay at another company.

New Compensation Discussion and Analysis Section. Another key feature of the proposed rules is the new Compensation Discussion and Analysis (CD&A) section, in which companies will be required to communicate their goals and objectives for executive compensation. This new section is clearly designed as a counterpart to the MD&A (Management's Discussion and Analysis) required in periodic SEC financial reports. The new CD&A section will replace the Compensation Committee report and the performance graph, which are currently required in proxy statements. It

is unclear what additional information not already required in the Compensation Committee report will be required. At its open meeting, the SEC pointed out that, under the current proposal, the CD&A section will be subject to the disclosure liability provisions of U.S. securities laws and to the certification requirements of Sarbanes-Oxley.

Perquisites. The item of executive pay that has received perhaps the most attention is executive perquisites. The proposed rules lower the threshold for disclosure of perquisites to \$10,000. (The current rules require disclosure of perquisites if their value exceeds the lower of an aggregate amount of \$50,000 or 10 percent of total annual salary and bonus.) Details are not yet available, but it appears that any perquisite valued over \$10,000 would have to be specifically disclosed. As noted above, the proposed rules will also contain guidance for determining what is a perquisite. The SEC has stated that the proposed rules will unveil a new test for this purpose, under which an item of executive pay will be a perquisite and not a legitimate business expense unless the item is "integrally and directly related" to the executive's job. In this area in particular, companies should examine their record-keeping procedures.

Stock Options. As noted above, the proposed rules provide for disclosure of the monetary value of stock options as of the date granted to top executives. Unlike the presentation in financial statements, however, as currently proposed, it is expected that the full value of the stock options would be presented all at once in the year of grant, rather than being amortized over the expected life of the option. One concern that has been raised about this requirement is that inclusion of the value of options could artificially inflate the total annual compensation figure, because options normally cannot be cashed in immediately and might never achieve their reported value.

Severance Arrangements. Another new table would require companies to specify the dollar amount of severance payments each named executive officer is entitled to receive, whether such payments are triggered by a change of control or a termination of the executive's employment. Although these arrangements generally have been described in narrative, few companies have elected to present their projected financial costs.

Deferred Compensation. Information about a named executive officer's deferred compensation would be disclosed in a separate table. This table would report contributions made by the company and the executives to deferral accounts during the year, as well as any earnings on the amounts in such accounts. Given the publicity over deferred compensation, this new table comes as no surprise.

Retirement Plans. Besides the addition to the Summary Compensation Table of the aggregate increase in the actuarial value of pension plans during the year, the proposed rules also provide for new tables in which companies disclose individual potential annual retirement benefits under qualified and nonqualified plans. The new tables would replace the current Pension Plan Table, which does not require figures to be broken down by executive. Although the details of this table will likely evolve during the comment period, most commentators are in agreement that changes in this area of compensation disclosure are necessary.

Director Compensation. Companies will have to disclose all payments received by directors during the year in a new table similar to the Summary Compensation Table, together with a related narrative.

Stock Pledges. For the first time, management will be required to disclose any pledges of company stock.

Plain English Requirement. As part of the SEC's effort to make executive compensation information more transparent to the public, the proposed rules provide that companies must use plain English in their proxy statements. Companies are already required to use plain English in their securities offering documents, and many companies have already taken this step with their proxies voluntarily. For others, the advent of these proposed rules presents an opportunity to reorganize their proxy statements and create a more consistent overall approach within the document.

GOOD NEWS

Although the proposals will require companies to expend substantial effort to make their proxy statements compliant, there is some good news. First, companies would no longer be required to include the performance graph in their

proxy statements. Second, the threshold for disclosure of certain related-party transactions would double from \$60,000 to \$120,000. Finally, the proposed rules seek to harmonize and organize the ongoing compensation disclosure system under Form 8-K and to collect all of the independence and related party requirements into a single new Item 407 of Regulation S-K.

EFFECT OF THE PROPOSED RULES ON EXECUTIVE PAY

The SEC's desire for greater transparency seems to have pleased some of those calling for reforms. The proposed rules arguably will allow investors and analysts to gauge more easily and precisely which named executive officers are receiving certain types of compensation and how much those executives are receiving in the aggregate. It remains to be seen, however, whether transparency in executive pay will curb its upward trend.

* * * * *

The foregoing is a highly condensed and generalized discussion of some key provisions of recently announced proposed rules. The information contained in this *Commentary* is based on the comments of the SEC Commissioners and staff at the open meeting on January 17, 2006. A detailed review of the text of the proposal after its publication will be necessary, and the discussion in this summary may be supplemented based on that review. Additionally, as is the case with all rule-making by the SEC, the final rules enacted following the 60-day comment period may differ from the proposed rules discussed herein.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which may be found at www.jonesday.com.

Lisa K. Kunkle
1.216.586.1093
lkunkle@jonesday.com

Louis Rorimer
1.216.586.7224
lrorimer@jonesday.com

Jones Day Commentaries are a publication of Jones Day and should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at its discretion. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship.