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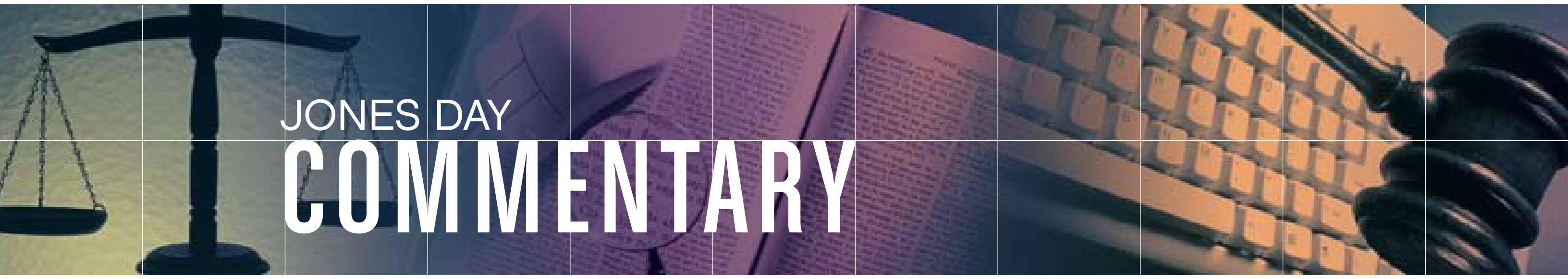


# NEW EXECUTIVE PAY PROPOSALS

The SEC's comprehensive new proposals for disclosure of executive compensation in the proxy statements of U.S. public companies respond to 14 years of developments in executive compensation since the last major SEC overhaul in 1992. The proposed rules cover issues relating to disclosure not only of executive and director compensation but also of related-party transactions and corporate governance, as well as certain disclosures required by Form 8-K. While nothing in the proposed rules mandates specific changes in executive pay, it appears that the SEC's goal is to encourage companies to look at total compensation and actually take action if the compensation appears to be ineffective or inappropriate.

## IMMEDIATE IMPACT

Although the new rules will not apply to proxy statements for calendar-year companies in 2006, they will have an immediate impact on all U.S. public companies. Companies will need to focus on the proposed changes now, because compensation decisions made today will have to be disclosed later under the new rules. 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 will even be affected by interpretive guidance included in the proposals. For example, because the proposed rules seek to codify the SEC's position on perquisites, as discussed below, companies need to be aware of that guidance when preparing this year's Summary Compensation Table. In addition, as proxy statements are prepared for this year's annual meetings, it may be the case that many companies interested in demonstrating sensitivity to shareholders' expressed interest in improved compensation disclosure may begin to comply voluntarily with some of the concepts that have been proposed, such as disclosure of an aggregate total compensation figure.

## THE NEW DISCLOSURES

**New Compensation Discussion and Analysis Section.** A key feature of the proposed rules is the new Compensation Discussion and Analysis ("CD&A") section, which will require compensation committees to communicate their goals and objectives for executive compensation. This new section is designed as a counterpart to the Management's Discussion and Analysis ("MD&A") required in periodic SEC financial reports. The new CD&A section will replace the Compensation Committee report and the performance graph. The proposals include some helpful guidance, indicating that the information provided in the new CD&A section will be very similar to the existing Compensation Committee report—but without being over the names of the Compensation Committee members. The most significant change is that now the CD&A section will be soliciting material and will be filed with the SEC, thereby subjecting the company and/or the signing officer to the disclosure liability provisions of securities laws. Furthermore, if the CD&A is included or incorporated by reference in a periodic report, the disclosure would be subject to the certification requirements of Sarbanes-Oxley. This means that an officer would have to certify that: (1) he or she reviewed the report; (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact; and (3) based on the officer's knowledge, the financial statements and other financial information fairly present in all material respects the financial condition and results of operation of the company. The implicit result of this requirement under the proposals is that management will now need to certify the information in the CD&A, an outcome that seems anomalous, given that Compensation Committees often meet in executive session, ensuring that management will have only hearsay knowledge about some of the reasons for compensation decisions.

**Total Annual Compensation.** Another important change under the proposed rules is a requirement that companies report the total annual compensation of their CEOs, CFOs, and three other most highly compensated executive officers (collectively, the "named executive officers"). In addition, as under the current rules, the same disclosures must also be made for up to two additional individuals who otherwise meet the disclosure requirements for named executive officers except for the fact that the individuals were no longer serving as executive officers at the end of the fiscal year. Identification of the most highly compensated executive officers will be based on total compensation for the fiscal year—not just salary and bonus, which is currently the basis for this determination. Total annual compensation figures would appear in the first column of the Summary Compensation Table in the proxy statement and would aggregate the dollar value of all forms of compensation reported in the other columns of the Summary Compensation Table. Other notable items in the revised Summary Compensation Table that will be part of the total annual compensation figure include the following:

- The present value of stock options granted for the year, valued as of the grant date, as discussed below.
- An expanded scope for the "All Other Compensation" column, as discussed below.

This "apples plus oranges" approach to total annual compensation is likely to produce some unexpected results. It remains to be seen whether these numbers will be useful for comparing executive pay at one company with the pay at another company. Of greater concern is the amount of work that will be required to calculate the total compensation of executive officers who may never be in the table, simply to determine whether or not their compensation information must be disclosed.

For the first time, companies must also report the total annual compensation for up to three of its most highly compensated employees who were not executive officers and who were paid more than any of the named executive officers. While such employees need not be identified by name, the company must provide a description of those employees' positions. It is unclear whether this information will prove to be valuable since the information is likely to be somewhat random, depending on the nature of the company's business. In addition, as discussed above with respect to the named executive officers, it could be burdensome for companies to determine if the total annual compensation of any employee must be disclosed.

**Changes to the "All Other Compensation" Column in the Summary Compensation Table.** In addition to requiring a new column for Total Annual Compensation, the proposed rules would move into the "All Other Compensation" column the items reported currently in the column entitled "Other Annual Compensation." This change serves to eliminate the current confusion between those two columns. For example, under the current rules, there has been uncertainty about where the cost of life insurance, other than certain split-dollar arrangements, should be reported in the Summary Compensation Table. Because there is now only one column covering compensation not specifically addressed in the other columns, the proposed rules actually clarify that all benefits not specifically provided for, such as life insurance costs, should be included in the “catchall” column—“All Other Compensation.” Under the proposed rules, the following items would be included in the “All Other Compensation” column:

- Perquisites and other personal benefits.
- Tax gross-ups.
- Amounts paid or accrued under a plan or arrangement in connection with a termination of employment or change in control.
- The dollar value of company-paid insurance premiums for life insurance for the benefit of a named executive officer.
- Contributions made by the company to defined contribution plans.
- The aggregate annual increases in the actuarial value of pension plan and SERP benefits.
- Earnings on nonqualified deferred compensation.

**Stock Options.** The proposed rules provide for disclosure of the monetary value of stock options as of the date granted to top executives in a column of the Summary Compensation Table. Unlike the presentation in financial statements, however, as currently proposed, the full value of the stock options would be presented 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 exercised immediately and might never achieve their reported value.

**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 from the current requirement of the lesser of an aggregate amount of $50,000 or 10 percent of total annual salary and bonus. Under the proposed rules, if the aggregate value of the perquisites is greater than $10,000, perquisites would have to be included in the “All Other Compensation” column and identified by type in a footnote. Furthermore, each perquisite valued at the greater of $25,000 or 10 percent of a named executive officer’s total perquisites would have to be specifically identified by type and amount in a footnote. Under the proposals, perquisites and personal benefits for directors would also have to be disclosed according to the same thresholds used for executive officers. In this area in particular, companies should examine their recordkeeping procedures. The attached appendix presents a diagram showing how the proposals define perquisites and how they would be disclosed in the Summary Compensation Table under the proposals.

After many years of silence, the SEC has taken this opportunity to set forth guidance on the items that constitute perquisites. While declining to stipulate a black-letter definition, the proposals provide some guidance and examples. An item of executive pay that confers a direct or indirect benefit that has a “personal aspect” will be a perquisite or other personal benefit unless the item is “integrally and directly related to the performance of the executive’s duties” or unless the item is generally available on a nondiscriminatory basis to all employees. An item satisfying those guidelines will be considered a perquisite or other personal benefit whether or not a company provides the item for a business reason or for the company’s convenience. In the proposals, the SEC cautions against interpreting the concepts of perquisites and other personal benefits “artificially narrowly.” To that end, the SEC explains that the “integrally and directly related” exception should not be broadly construed. For example, this exception would cover office space or a reserved parking space at a company business location, but the exception would not extend to the use of company-provided aircraft or investment management services.

In the proposals, the SEC provides the following examples of items that would and would not qualify as perquisites and personal benefits under the new guidance:

- **Perquisites**—Club memberships not used exclusively for business entertainment purposes; personal financial or tax advice; personal travel using vehicles owned or leased by the company; personal travel otherwise financed by the company; personal use of other property owned or leased by the company; housing and other living expenses, including relocation assistance and payments for the executive or director to stay at his or her personal residence; security provided at a personal residence or during personal travel; commuting expenses; and discounts on company products or services not generally available to employees on a nondiscriminatory basis.
- **Not perquisites**—Business entertainment, travel to and from business meetings, security during business travel, and itemized expense accounts if limited to business purposes.

The proposed rules also reiterate that the proper measure of the value of perquisites and other personal benefits is the aggregate incremental cost to the company. The Standard Industry Fare Level ("SIFL") rules, used to value the cost of aircraft travel for federal tax purposes, may not be used to value such travel for purposes of proxy disclosures. Much to the disappointment of many, the proposals provide no further guidance related to valuation of the personal use of aircraft by company personnel and their families.

**Retirement Plans.** Besides providing for the inclusion of the aggregate increase in the actuarial value of pension plans during the year in the "All Other Compensation" column of the Summary Compensation Table, the proposed rules also provide for a new table and related narrative description in which companies disclose estimates of individual annual retirement benefits payable at normal retirement age and at early retirement, if available, under qualified and nonqualified plans. The new table 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. Whether these changes will adequately address disclosure issues relating to retirement plans remains to be seen.

**Deferred Compensation.** Information about a named executive officer's nonqualified defined contribution and deferred compensation plans 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 the earnings and balances of such accounts. Currently, only above-market earnings on nonqualified deferred compensation must be disclosed. Given the publicity over deferred compensation, this new table comes as no surprise.

**Severance Arrangements.** Another new disclosure would require companies to specify the dollar amount of severance payments each named executive officer is entitled to receive and whether such payments are triggered by a change in 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. One obvious problem with determining such projected financial costs is that the SEC failed to provide guidance as to permissible assumptions (*e.g.*, payout date and stock price) for use in calculating these costs. This guidance is especially significant for change-in-control agreements that provide for excise tax gross-ups. In calculating costs under this type of arrangement, assumptions as to the date of the change in control, the deal price, and the executive's compensation at that time would have to be made, which could produce a wide range of results. Although not required to do so by either the current or proposed rules, some companies have started using a table to present this information.

**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. Requiring disclosure of actual meeting fees paid has the potential to become overly invasive in that a table displaying an abnormally high amount of meeting fees could signal increased time spent by board members on confidential matters, such as the sale of the company or the hiring or firing of an executive officer. Thus, it is a concern that companies will be reluctant to call multiple meetings to avoid having to disclose the compensation earned at such meetings. This type of disclosure is also likely to encourage companies to set director compensation on terms that operate without reference to attendance at meetings.

**Revisions to Items 1.01 and 5.02 of Form 8-K.** The SEC's intention for these revisions is to restore a more balanced approach to current disclosure about executive compensation. In the proposals, the SEC essentially acknowledged that the staff's ad hoc attempt to use Form 8-K to overturn long-standing interpretations of the exhibit disclosure requirements had produced somewhat inconsistent results. The proposed rules seek to rectify that problem by restructuring current Items 1.01 and 5.02 of Form 8-K. In addition, the SEC states in its proposals that it recognizes that management will have to make rapid materiality and similar judgments to determine if a matter must be disclosed under the rules governing Form 8-K disclosures. Accordingly, the proposals provide that a company will not lose its eligibility to use Form S-3 if the company is late filing a report under the relevant provision of Item 5.02 of Form 8-K.

**Stock Pledges.** For the first time, companies will be required to disclose the number of shares of company stock pledged as collateral for loans taken by the companies' directors and five highest-paid executive officers. This new disclosure would be made in a footnote. The proposals indicate that the SEC is concerned about the potential for stock pledges to affect the decisions made by directors and executive officers.

**Related-Party Transactions.** The proposals would significantly revise Item 404 of Regulation S-K so as to streamline and modernize the disclosure requirements for related-party transactions. Item 404 would set forth a general statement of the principle for disclosure in addition to some particular disclosure requirements. Specifically, a company must disclose any transaction, or currently proposed transaction, since the beginning of the last fiscal year in which (i) the company is a participant, (ii) the amount involved is greater than $120,000, and (iii) any related person had or will have a direct or indirect material interest. The proposals make clear that the term "transaction" should be broadly interpreted, and the proposed rules specifically define the term to include indebtedness and guarantees of indebtedness. The proposed rules would require companies to describe their policies and procedures for review, approval, or ratification of related-party transactions that would be reportable under Item 404. Many companies have already established such policies and procedures regarding conflicts of interest, but those companies that do not yet have any such written policies or procedures will need to consider adopting something for this purpose.

**Conforming Amendments for the Definition of "Non-Employee Director."** The SEC is proposing conforming amendments to the definition of "non-employee director" in Rule 16b-3 of the Exchange Act to take into account the changes being made under the proposals to Item 404. The SEC's intent, as stated in the proposals, is to minimize potential disruptions, because it is unaware of any problems with the current definition. In some cases, however, the new expanded principles-based disclosure under new Item 404 may cause some current non-employee directors to become ineligible under Rule 16b-3 of the Exchange Act, even though the disclosure threshold of Item 404 is being raised from $60,000 to $120,000. Thus, if the rules are enacted as proposed, companies should be sure to retest their compensation committee members to ensure that all such members still qualify as non-employee directors.

**Corporate Governance.** The proposals also call for a new item (Item 407), which would consolidate disclosure requirements relating to director independence and corporate governance. The new rules would require disclosure of whether each director and director-nominee is independent and whether any audit, nominating, and compensation committee members are not independent, using a definition for independence that is in compliance with the applicable listing standards. The proposed rules would also require a description of any relationships not otherwise disclosed that were considered when determining whether each director and director-nominee is independent. Additionally, companies that have adopted definitions of independence for directors and committee members would have to disclose whether those definitions are posted on their web sites or would have to include the definitions as an appendix to their proxy statements every three years. The audit committee charter will no longer be required to be delivered to shareholders as an appendix to the proxy statement if it is posted on the company's web site. Finally, additional disclosure regarding the compensation committee's processes and procedures for the consideration and determination of executive and director compensation (like the current disclosure relating to audit and nominating committee matters) will also be required. For example, a company will have to describe:

- The scope of authority of the compensation committee.
- The extent to which the compensation committee may delegate its authority.
- Whether the compensation committee's authority is set forth in a charter or other document.
- Any role of executive officers in determining or recommending the amount or form of executive and director compensation.
- Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation.

**"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 to 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, as mentioned above, the threshold for disclosure of certain related-party transactions would double from $60,000 to $120,000. Additionally, the proposed rules seek to collect all of the independence and related-party requirements into a single new Item 407 of Regulation S-K. The SEC also appears to be backing away from exhaustive executive compensation disclosures on Form 8-K, based on its acknowledgment in the proposals that the current Form 8-K rules have resulted in disclosures of nonmaterial executive compensation information.

## 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.

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The foregoing is a highly condensed and generalized discussion of some key provisions of the proposed rules. As is the case with all rulemaking by the SEC, the final rules enacted following the 60-day comment period, which ends on April 10, 2006, 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 can be found at www.jonesday.com.

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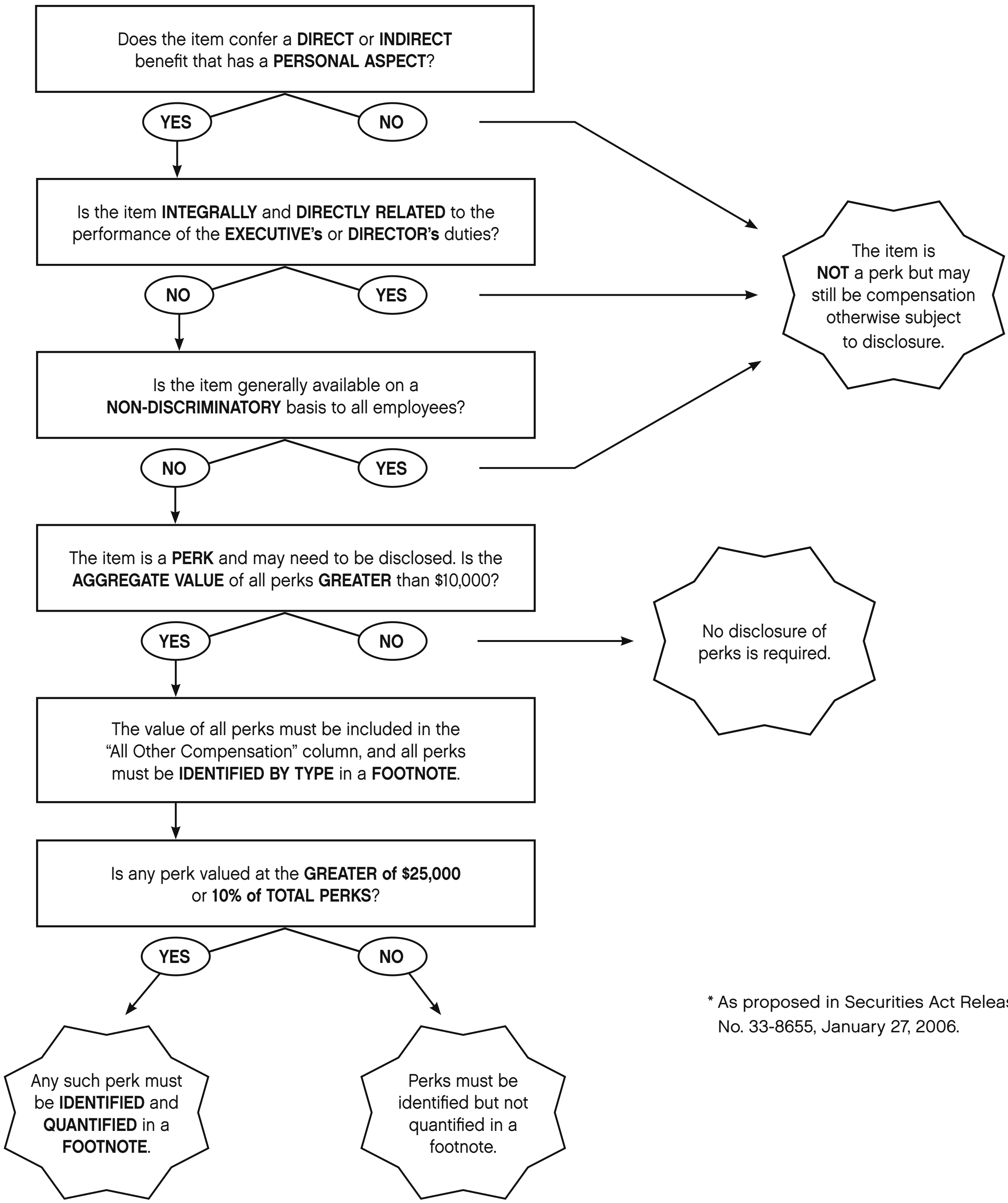
# APPENDIX

## Disclosure of Perquisites and Other Personal Benefits ("Perks")*

This flow chart is designed to test whether an item of executive compensation should be treated as a perquisite and how it should appear in the Summary Compensation Table. Any item that would fall in the "All Other Compensation" column can be tested, except for amounts such as tax gross-ups, severance pay, and life insurance that are separately addressed in the rule.




* As proposed in Securities Act Release No. 33-8655, January 27, 2006.