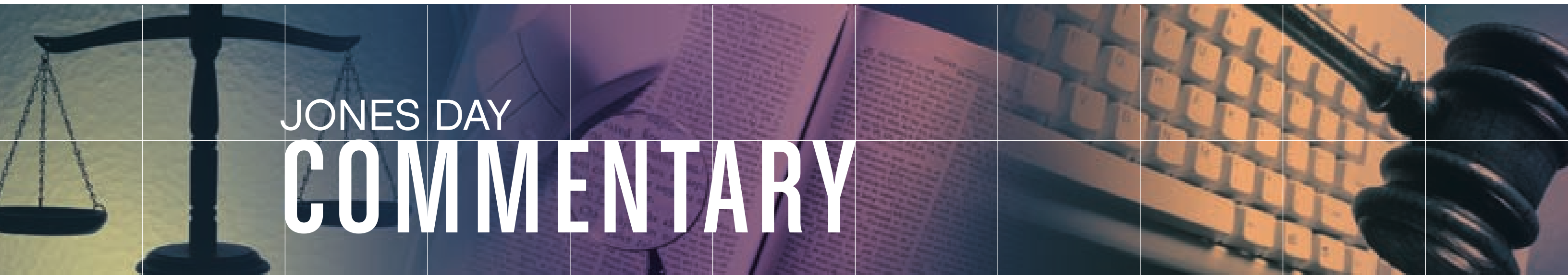
OCTOBER 2006



RELATED PERSONS, INDEPENDENCE OF DIRECTORS, AND EXECUTIVE PAY DISCLOSURE: WHAT THE SEC WANTS NOW

On November 7, 2006, the SEC's new executive compensation and corporate governance rules will begin to go into effect.[1] Our previous Commentaries have described the detailed provisions of the Release.[2] This Commentary reports on several of the real-world challenges these new rules are already presenting for U.S. public companies. U.S. public companies need to be prepared for these new rules for the 2007 proxy season, or sooner in the event a company files a registration statement after December 15, 2006.

TRANSACTIONS WITH RELATED PERSONS

The SEC wants companies to apply "principles" instead of the current numerical formulas in determining when a related party transaction requires proxy statement disclosure.

What's Changed. In theory, nothing has drastically changed, but the rule has been completely rewritten, so new interpretations and unexpected results are likely to emerge. Item 404 of Regulation S-K has been restructured to eliminate the numerical safe harbors previously contained in Item 404(b), while raising the *de minimis* threshold from $60,000 to $120,000.

Discussion. New Item 404(a) requires disclosure of all transactions, relationships, or arrangements that are material to the related person, except for matters excluded by a few narrow exceptions. There are no quantitative lower limits any more (other than the *de minimis* exception), so it will be a challenge to filter out background noise from material transactions. Transactions by family members are likely to attract special attention, and it will be important to find out about all transactions between a director or officer's family members and the company.

1. Securities Act Release No. 8732 (August 11, 2006).
2. "Final Executive Pay Proposals Adopted by the SEC," Jones Day Commentary, July 2006; "Final Executive Compensation and Related Person Disclosure Rules," Jones Day White Paper, October 2006.

Our Recommendation. Principles should work both ways. If a transaction, relationship, or arrangement really is immaterial in light of well-considered judgment, companies are not obliged to disclose it just because it exceeds the new $120,000 threshold. The annual D&O questionnaire will need a lot of work this year to reflect all of the new rules, so be sure it captures basic information about transactions between directors, officers, their family members, and the company; then, track down the details from verifiable company records and consider materiality thoughtfully.

POLICIES FOR REVIEW OF RELATED PERSON TRANSACTIONS

For the first time, this year's proxy statement will need to describe the company's "policies and procedures" for reviewing transactions with related persons.

What's Changed. This is a new requirement.

Discussion. Although Sarbanes-Oxley and related stock exchange initiatives spawned a variety of newly required policies and procedures (codes of ethics, corporate governance guidelines, committee charters, etc.), they did not specifically mandate a conflict-of-interest policy for public companies. The NYSE's long-standing rule on this subject was merely advisory.[3] The SEC evidently noticed this vacuum and filled it with new Item 404(b) of Regulation S-K. Now, public companies are required to have a policy and to describe it.

Our Recommendation. First, look for policies (written or unwritten) that may already exist, such as "codes of conduct." There may be more than one for different staff levels or business units. Then decide what procedures make the most sense for your company. It may boil down in substance to: "We do not permit officers or directors or their close family members to enter into transactions with the company for their personal benefit. Any uncertainties are resolved by [fill in the blank]."

INDEPENDENCE DETERMINATIONS

The SEC wants all skeletons out of the closet. Proxy statements will now have to disclose *all* transactions, relationships, and arrangements that the Board of Directors considered in determining that directors were independent.

What's Changed. Since Sarbanes-Oxley, companies have had to disclose any director who was *not* independent and why. Now they also have to explain why the Board of Directors determined that a director *was* independent, despite any existing relationship, and describe it.

Discussion. In the aftermath of Sarbanes-Oxley, the stock exchanges implemented director independence standards and, in some cases, permitted an issuer to adopt and disclose "categorical standards" to assist it in making independence determinations.[4] Curiously, the exchanges did not require disclosure of any potential independence problems that could pass muster under the categorical standards or independence definition. Many companies moved quickly to adopt the objective portion of the stock exchange rule as their own categorical standards, with the result that any independence issue that required subjective evaluation by a Board of Directors seemed to escape disclosure. This anomalous result set off a confusing series of regulatory attempts to straighten out this circular dilemma, which has now finally culminated in new Item 407(a). It requires disclosure not only of the company's definition of independence, but also of any transactions, relationships, or arrangements that were considered in applying it.[5] Note that the transactions, arrangements, and relationships picked up by new Item 407(a) are not subject to any materiality or *de minimis* thresholds and therefore have the potential to significantly widen the scope of related person transactions being considered.

Our Recommendation. As part of the company's independence standards, make sure you have a filter in place for ordinary-course transactions that have no implications for independence and do not merit director consideration, such

3. NYSE, Inc. Listed Company Manual Section 307.00.
4. NYSE, Inc. Listed Company Manual Section 303A.02.
5. Item 407(a)(3) of Regulation S-K.

as retail purchases of company products by directors or their family members at market prices (or at ordinary employee discounts). Be prepared, however, to describe why a director is independent despite any relationship that the Board of Directors is obliged to consider.

OPTION PRICING

The SEC wants to know if a company priced options at anything other than the closing sale price of the underlying stock on the actual date of Board or Committee approval.

What's Changed. For many years, companies have used a variety of ways to peg fair market value for option grants: closing price (last sale) on the day before grant, average of the high and low prices on the day before (or the day of) grant, etc. Now, in reaction to the recent rash of option backdating investigations, the SEC has implemented an array of narrative and tabular disclosure requirements designed to capture irregularities and impose normative behavior.

Discussion. There is essentially no law in the area of option pricing, and even the SEC Commissioners have not been able to agree on many best practices. Indeed, as of this writing, the SEC has put the Chief Accountant out front to catch the flak, leaving unanswered questions on many other important points.[6] Even with that uncertainty, it remains clear that no committee (or duly authorized delegate) should grant options too far in the future without knowing the actual, final price. In fact, we have some reservations about the practice of using the closing price on the date of grant if the committee adjourns its meeting before the market closes. Even formula grants may not be the perfect solution in every case.

Our Recommendation. Don't be rushed into changing well-established practices unless you are convinced there is a better way. If you are going to use market closing price on the grant date, consider holding your compensation committee meeting in the late afternoon. In any event, your accountants should be consulted in connection with any decisions regarding your option pricing practices.

PARACHUTE TAX GROSS-UPS

The SEC wants companies to tell shareholders how much the tax gross-up (if one exists) is going to cost if the senior executives ever pull the rip cord on their parachutes. The simple answer is almost always going to be, "A lot."

What's Changed. Companies used to be able to get by with long narrative descriptions of change-in-control severance agreements without mentioning any dollar amounts. Now they have to disclose all the values and other parameters, including a specific confession if they use a "single trigger."

Discussion. Current Item 402(a) only required issuers to describe the "terms and conditions" of change-in-control arrangements. It was a fair reading of this item to skip the numerical implications, especially since the full text of the agreements was publicly available as an exhibit to the Form 10-K. Anyone could figure out the values with the help of a lawyer, two tax accountants, an actuary, and a laptop. New Item 402(j), however, leaves no doubt that the SEC wants companies to describe and quantify (and don't forget the perks).

Our Recommendation. If companies have not already done so as part of a "tally sheet" exercise, they should count those gross-up chickens before they hatch. The numbers may well produce the proverbial "holy cow" moment. Companies should make sure they are prepared to stand behind the agreements once the dollars are disclosed, or get started making changes.

PERFORMANCE TARGETS

If you can't say with a straight face that disclosure of your actual, numerical performance targets for compensatory awards will cause "competitive harm," stand by to disclose them in this year's proxy.

What's Changed. Since 1993, companies have been allowed to disclose only the general nature of the performance criteria used in measuring performance-based

6. Letter dated September 19, 2006, from Chief Accountant Conrad Hewitt.

pay, such as EPS, EBITDA, or TSR. Now the SEC is explicitly imposing the same disclosure regime in this area that applies for "confidential treatment" filings, which are driven by the strict rules under the Freedom of Information Act.

Discussion. This means that if a company's performance award pays out at 100 percent when its earnings increase by, say, 15 percent, it will need to disclose exactly that. In addition, if the tests constitute "non-GAAP financial measures," the company will have to provide additional disclosure—such as reconciliation back to the best GAAP starting point—under the principles that apply to such figures. These disclosures can present some troubling implications when they join the mix of other forward-looking information in the marketplace.

Our Recommendation. It is too late to change existing long-term incentive plan targets that are in mid-cycle, without drastic readjustment of employee expectations. Companies should instead concentrate on whether they can substantiate that they meet the "competitive harm" standard and think about what targets to use for future awards.

DIRECTOR PERQUISITES

Everyone knows that officer perquisites are under incredible scrutiny, but nobody thought much about disclosure of perquisites for directors until recently. Now the SEC has made it abundantly clear that director perks have to be disclosed, too.

What's Changed. New Item 402(k) requires tabular disclosure of director pay and specifically includes perquisites using the same formulation that applies to the named executive officers.

Discussion. Current Item 402(g) simply asked for information about "standard" and "non-standard" pay arrangements for directors. Since there was no mention of perks, which were specifically required for executive officers, many people reasonably assumed there was no obligation to describe perks for directors. An informal SEC Staff position suggested otherwise, but that guidance was difficult to find without a lot of effort,[7] and nobody knew whether it was really dispositive.

Our Recommendation. Many apparent director perks—flying on the company plane to a board meeting or the cost of hotel rooms—are not really within the definition of perquisites, because they are directly and integrally related to the performance of the director's duties. The rest often don't amount to much and may well be under the aggregate $10,000 *de minimis* threshold. But companies should take a look at their director perks now and think about how they will look in print. If possible, look at peers' proxies first before changing practices that may be perfectly consistent with industry standards.

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.

Lisa K. Kunkle
1.216.586.1093
lkunkle@jonesday.com

Louis Rorimer
1.216.586.7224
lrorimer@jonesday.com

Stephen P. Coolbaugh
1.216.586.7226
spcoolbaugh@jonesday.com

7. Technical Session Between the SEC Staff and the ABA Joint Committee on Employee Benefits, May 4, 2004, Question 7.