

Client Alert

SEC Amends Proxy Disclosure Rules to Align Better With FAS 123R

On Friday, December 22, 2006, the U.S. Securities and Exchange Commission (SEC) issued amendments to the recently released proxy disclosure rules related to executive and director compensation. These amendments take the form of interim final rules that will be effective upon publication in the Federal Register. These amended rules will have the same effective date as the previously announced new proxy disclosure rules, i.e., they will apply to proxy statements, information statements, and registration statements filed on or after December 15, 2006 that must include the Item 402 compensation disclosures covering fiscal years ending on or after that date. The amendments will also apply to Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006. While the rules are published as interim final rules, the SEC has provided a thirty (30) day comment period and will revise the rules if necessary following the comment period.

Source Documents

The SEC announced these amendments in Press Release 2006-219¹, which includes a link to the full amendments².

Key Changes

The key changes to the proxy disclosure rules are highlighted below:

- **Summary Compensation Table (SCT)** –
 - The dollar values that are disclosed in the Stock Awards and Option Awards columns are revised to disclose the compensation cost of those awards, before forfeitures, over the requisite service period (vesting period), as described in FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123R). In other words, the amount shown in the SCT will be the grant date fair value recognized ratably over the requisite service period. This means that the amounts shown in the SCT will reflect awards granted in prior years that were not fully expensed as of the beginning of the current fiscal year. For example, if a company uses 3 year vesting and generally grants awards in February, the value shown in 2006 would typically include the accounting expense attributable to 2006 for awards granted in 2003, 2004, 2005, and 2006.
 - Forfeitures are to be discussed in footnotes to the Stock Awards and/or Option Awards columns, as appropriate. Further, to the extent equity forfeitures or other reductions in equity compensation expense occur during the year, the amount shown in the relevant equity column of the SCT can be negative, thus reversing any value previously disclosed.
 - As noted above, these changes will apply to all awards that were expensed during the past fiscal year, even those that were granted prior to the time the company adopted FAS 123R. In requiring this for determining the values to be disclosed in the SCT for outstanding equity and liability awards, the SEC indicated that companies will be utilizing the modified prospective transition method for awards under FAS 123R, regardless of how or when the company actually adopted FAS 123R.
- **Grants of Plan-Based Awards Table (GPBAT)** –
 - The table has been revised to include a new column that reports the grant date fair value of each individual equity award, as computed in accordance with FAS 123R (*see* Exhibit 1 which includes the revised table). In essence, the values originally required to be disclosed in the SCT under the July, 2006 rules are now moved to the GPBAT.

¹ <http://www.sec.gov/news/press/2006/2006-219.htm>

² <http://www.sec.gov/rules/final/2006/33-8765.pdf>

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- Companies must disclose any option or SAR that was repriced or otherwise materially modified during the last completed fiscal year, including the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R.
- **Director Compensation Table (DCT) and Required Footnotes** – In short, the same changes required for the SCT and GPBAT will apply to the DCT and its required footnotes. That is, the DCT will reflect the expense of all awards attributable to the last fiscal year (covered by the proxy) under FAS 123R and the full value of awards granted during that year must be addressed in corresponding footnotes.

EXEQUITY's Quick Take

These changes are likely to trigger a variety of disclosure and other executive compensation issues:

- **Greater Consistency in the Executives Disclosed** – One of the reasons that the SEC notes for the change is that this disclosure will allow for more consistency in the NEOs disclosed – the theory being that large, one-time grants will be disclosed (and counted) over the requisite service period.
- **Retirement Eligibles will Appear to be Higher Paid** – Many equity awards provide for full or partial vesting upon retirement causing the expense associated with the awards (and thereby the amount disclosed) to be accelerated. Thus, officers at or approaching retirement age will have accelerated expense recognition and higher numbers for SCT purposes, including the determination of NEOs. This may run directly counter to the SEC's view that greater consistency in the NEOs being disclosed will occur. That is, lower level officers who are approaching retirement age may become NEOs as a result of these revised rules.
- **Terminated Officers Less Likely to be Disclosed** – Since forfeitures cause prior amounts to be reversed, terminated officers may again escape disclosure where equity forfeitures significantly offset any cash severance.
- **Liability Awards Under FAS 123R Will Have a Lingering Effect** – These rules indicate that awards treated as liability awards (generally cash-settled equity awards such as cash SARs) will continue to be marked-to-fair value through the proxy until the awards are settled, which can be well after the award have in fact vested. While these awards are not extremely common, they can have a significant effect on the determination of NEOs to be disclosed.
- **Continuing Inconsistencies in Disclosure of Different Award Types** – Generally speaking, the SCT is now very closely tied to the accounting cost of the compensation provided an officer in a given fiscal year. However, long-term cash awards not accounted for under FAS 123R continue to be disclosed in the year in which the performance requirements have been achieved, even though the awards are expensed over the entire performance period. Thus, the SEC's objective of allocating awards over the period earned is not fully achieved by this change.
- **Method of Analyzing Competitive Pay Levels May Change** – Historically, most companies conducted competitive pay studies based on the full grant values of awards made by competing companies in the prior 1 to 3 years. While the SEC has stated that they do not intend the rules to curb executive pay, they may cause companies to reconsider how they evaluate executive pay going forward – the SEC rules may persuade companies to compare pay based on when earned as opposed to when awarded.
- **Companies Need to Reevaluate Their Disclosures Immediately** – Companies that prepared their SCT before these amendments were announced will need to revisit the table to determine if their NEOs will remain the same. In some cases, especially where an executive received special, one-time large equity awards this past year and is unlikely to receive equity grants at that level going forward, it is likely that the company's NEOs will now change. Companies thus should ensure they check their NEOs quickly to determine if any new executives make it into the SCT and other tables. If so, companies will need to move swiftly to ensure the relevant data for such newly included executives is gathered and input into the appropriate tables and accompanying footnotes and narratives.

Exhibit 1 – Grants of Plan-Based Awards Table³

Name	Grant Date	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 (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise of Base Price of Option Awards (\$/Sh)	Grant Date Fair Value of Stock and Option Awards
		Threshold (\$)	Target (\$)	Maximum (\$)	Threshold (#)	Target (#)	Maximum (#)				
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)
PEO											
PFO											
A											
B											
C											

³ Revised Grants of Plan-Based Awards table as disclosed in SEC Release Nos. 33-8765; 34-55009, p. 50 (December 22, 2006). Revisions are highlighted.



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