

CORPORATE AND SECURITIES LAW

Alert

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

SEC Proposed Rules On Executive and Director Compensation Disclosure

February 17, 2006

On January 27, 2006, the Securities and Exchange Commission published proposed rules relating to executive and director compensation disclosure required in public company proxy statements and other SEC filings. The proposed rules are consistent with the description of the rules provided by the SEC during the open meeting in which it voted to propose the rules and the related SEC press release. See our Alert of January 17, 2006 at <http://www.bassberry.com/resources/index.html>.

The SEC will accept public comment on the proposed rules until April 10, 2006, after which it will consider the comments and act on final rules. The SEC has proposed that, following their adoption, the rules will become effective for proxy statements that are filed at least 90 days after publication of the final rules. As a result, except for the interpretive guidance regarding perquisites which we discuss below, the proposed rules are not expected to be effective with respect to companies that file their proxy statements during the Spring 2006 proxy season. The SEC does not currently intend that companies “re-state” compensation disclosure for fiscal years covered by current rules. Instead, the first proxy filed by companies after the proposed rules become effective will be required to include information for only the most recent fiscal year (and the second proxy will be required to include information for the two most recent fiscal years). Thus, the proposed rules would be phased in over time. Other aspects of the proposed rules become effective at different times. For example, the Form 8-K revisions become effective for triggering events that occur at least 60 days after publication of the final rules.

This Alert provides an overview of the proposed rules, including our initial observations regarding some of the more noteworthy and potentially controversial aspects of the proposal. It also discusses the interpretive guidance regarding prerequisites which applies immediately and must be considered by each issuer when completing its proxy statement for its 2006 meeting. Finally, this Alert draws attention to steps issuers should consider taking now or in the near future to prepare for the proposed rules becoming effective.

Overview of the Proposal

New “Compensation Discussion and Analysis” section

Under the rule proposal, compensation disclosure would be under the framework of a new “Compensation Discussion and Analysis” section. This “CD&A” section would replace the Compensation Committee Report as well as the stock performance graph.

Much like the current MD&A section, the CD&A section would require a frank, principles-based discussion that is tailored to the company and avoids boilerplate language. The CD&A would be an overview of the company’s overall compensation objectives, a discussion of the material factors underlying those objectives, and an analysis of how each element of compensation is intended to and succeeds in furthering those objectives. We have included an excerpt from the SEC’s “Background and Overview of the Proposals” which lays out the SEC’s expectations with respect to this new disclosure.

The proposed rules would require that the CD&A address at a minimum:

- the objectives of the compensation program;
- what it is designed to reward and not reward;
- each element of compensation;
- why the company chooses to pay each element of compensation;
- how the company determines the amount (and, where applicable, the formula) for each element of compensation; and
- how each element and the company’s decisions regarding that element fit into the company’s overall compensation objective and affect decisions regarding other elements.

The proposal also provides a list of examples of topics potentially appropriate for the CD&A (see the Excerpt included in this Alert).

The proposal includes an instruction, similar to the current instruction with respect to the Compensation Committee Report, stating that companies need not disclose target levels with respect to performance-related factors considered in the compensation process if the disclosure would have an adverse effect on the company. The standard to be applied in making such a determination is the one used when companies request confidential treatment of information that otherwise is required to be disclosed in documents filed with the SEC.

The CD&A would be company disclosure and would not be made “over the names” of the individual compensation committee members. Unlike the compensation committee report, the CD&A would be deemed “filed” with the SEC as part of the proxy statement and any other filing in which it is included. As a result, the CD&A would be: covered by the CEO and CFO certifications required to be made under the Sarbanes-Oxley Act; subject to the liabilities of Section 18 of the Securities Exchange Act; and subject to the more stringent liabilities of the Securities Act when incorporated into registration statements.

We believe that this change will generate substantial comment. The proposal states that the SEC believes (i) it is appropriate for companies to take responsibility for disclosures involving board matters, as with other disclosure, and (ii) that the current safe harbor from liability for compensation committee reports has not resulted in the more candid and fulsome disclosure that had

This excerpt is from the "Background and Overview of the Proposals" section of the SEC's proposed rule:

CD&A

...The purpose of the Compensation Discussion and Analysis disclosure would be to provide material information about the compensation objectives and policies for named executive officers without resorting to boilerplate disclosure. The Compensation Discussion and Analysis is intended to put into perspective for investors the numbers and narrative that follow it.

The proposed Compensation Discussion and Analysis requirement would be principles-based, in that it identifies the disclosure concept and provides several illustrative examples. The application of a particular example must be tailored to the company. However, the scope of the Compensation Discussion and Analysis is intended to be comprehensive, so that it would call for discussion of post-termination as well as inservice compensation arrangements. Boilerplate disclosure would not comply with the proposed item. Examples of the issues that would potentially be appropriate for the company to address in given cases in the Compensation Discussion and Analysis include the following:

- policies for allocating between long-term and currently paid out compensation;
- policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- for long-term compensation, the basis for allocating compensation to each different form of award;
- for equity-based compensation, how the determination is made as to when the award is granted;
- what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- how specific elements of compensation are structured to reflect these items of the company's performance and the executive's individual performance;
- the factors considered in decisions to increase or decrease compensation materially;
- how compensation or amounts realizable from prior compensation (e.g., gains from prior option or stock awards) are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits);
- the impact of accounting and tax treatments of a particular form of compensation;
- the company's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any company policies regarding hedging the economic risk of such ownership;
- whether the company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- the role of executive officers in the compensation process.

The Compensation Discussion and Analysis should be sufficiently precise to identify material differences in compensation policies and decisions for individual named executive officers where appropriate. Where policies or decisions are materially similar, officers could be grouped together. Where, however, the policy for an executive officer is materially different, for example in the case of a principal executive officer, his or her compensation would be discussed separately...

been predicted by commentators when the Compensation Committee Report was put into place. Subjecting the CD&A to the certification requirements and liability provisions of the Securities Exchange Act and Securities Act would, however, require the CEO and CFO to certify to a process that will include decisions about their own pay, a process that they are regularly divorced from for governance reasons and a process which regularly takes place in executive session with no representation by management.

We expect that for most companies, the CD&A will require significantly more disclosure than that currently provided by the Compensation Committee Report. As a result, we expect that complying with the new CD&A requirements will involve a significant time commitment from management, compensation committee members, and their advisors. In addition, the fact that the CD&A will be deemed “filed” will require increased attention to the documentation of a company’s compensation decision-making process in order to support CEO and CFO certifications made under the Sarbanes-Oxley Act.

Changes to persons included as named executive officers

Under the proposed rules, several changes would be made to the group of persons included as named executive officers – the officers for whom compensation disclosure is generally required. In addition to the company’s principal executive officer (the term replacing chief executive officer), the principal financial officer of the company (usually the chief financial officer) would automatically be a named executive officer. This should not constitute a major change from current practice, however, because the principal financial officer in most cases is already included as one of the most highly compensated executive officers of the company.

The three other highest-paid executive officers would also be named executive officers with a significant change in how compensation is to be calculated when making this determination. The determination of the other executive officers included would be made based on “total compensation” for the last fiscal year (as indicated in a new column (c) of the revised Summary Compensation Table). Under the current rules, this determination is made based on annual salary and bonus amounts only. Because “total compensation” under the proposed rules would include many more types of compensation than annual salary and bonus, the SEC proposal will likely make it more difficult for companies to determine in advance the three most highly compensated officers.

The proposal would require narrative disclosure of total compensation for up to three employees who were not executive officers but whose total compensation for the previous fiscal year was greater than that of any of the named executive officers. The disclosure would include only the employees’ total compensation and job positions – the employees would not need to be identified by name. We expect this aspect of the proposal to generate significant comment, especially from companies that pay significant commission, trading, sales or other performance-based bonuses to non-executive officers.

Summary Compensation Table

While the Summary Compensation Table would be retained under the proposed rules, it would also be reorganized and supplemented with additional narrative. In its revamped form, it would eliminate the distinction between annual compensation and long-term compensation.

New total compensation column. The first compensation column in the Summary Compensation Table would be a total of the compensation received by each named executive officer during the year. This column would represent the sum of each of the table's other columns – salary, bonus, stock awards, option awards, non-stock incentive plan compensation and all other compensation. The focus on total compensation will be challenging in instances when special, often one-time incentive grants (e.g., retention awards, sign-on bonuses, or buyouts of a previous employer's compensation package) are made to executives. Compensation Committees should be aware of the disclosure implications related to these compensation decisions.

Salary and bonus columns. These columns would be substantially unchanged except that (i) all amounts deferred for any reason (not just at the election of the executive as is currently the case) must be footnoted and (ii) a footnote must disclose if any salary or bonus is not determinable and when it will be determinable, with an 8-K being required when the salary or bonus is finally determined.

Stock awards column. The proposal would replace the existing "restricted stock awards" column with a new "stock awards" column that includes all stock-related awards deriving their value from the company's equity securities or permitting settlement in such securities, other than awards that have option-like features. Awards that would be reflected in this column include restricted stock, restricted stock units, phantom stock, phantom stock units and similar instruments. The dollar values for these awards would be included based on their grant date fair value pursuant to FAS 123(R) using the same valuation model and assumptions as the company's financial statements, without regard to the vesting conditions for the grants. The SEC has acknowledged that this approach creates a difference between when value is reported on financial statements and in the Summary Compensation Table, but has taken the position that full value reporting in the year of grant is "more consistent with the purposes of executive compensation disclosure." The SEC is likely to receive comments arguing that value should instead be reported in a manner consistent with the expense recognition for financial accounting purposes.

Currently, companies may elect to include stock awards subject to performance conditions in a separate LTIP table as opposed to the Summary Compensation Table. The proposal would eliminate this option and require companies to include the grant date fair value of such awards in the stock awards column of the Summary Compensation Table.

Earnings on stock awards, such as dividends or dividend equivalents, would be included in the stock awards column. Currently, such earnings are included only to the extent they are above-market or preferential. All earnings paid or payable would need to be identified and quantified in a footnote. As a result, the Summary Compensation Table would reflect the full amount of stock and option awards in the year that they are granted and also reflect earnings on such awards during the applicable vesting period.

Option awards column. Awards of options, stock appreciation rights (“SARs”) and other similar instruments with option-like features would be disclosed in an “option awards” column in a manner similar to the proposed treatment of stock awards. Instead of the current disclosure of the number of securities underlying the awards, this column would require disclosure of the grant date fair value of the award as determined pursuant to FAS 123R for financial reporting purposes.

The option awards column for a fiscal year would include the total fair value of any previously awarded options or SARs that are repriced or materially modified during the fiscal year. This would be the case notwithstanding that FAS 123R would require recognition of only the incremental compensation cost.

New non-stock incentive plan compensation column. A new column would report the dollar value of amounts earned during the year (determined by the year in which performance criteria are satisfied) under incentive plans; i.e., plans under which the performance measure is not based on the price of the company’s stock or where the payment will not be made in stock (as well as earnings on all outstanding awards). This column, which would replace the LTIP payout column, would show the compensation earned during the year, regardless of whether payment is actually made in that year to the named executive officer.

New all other compensation column. Consistent with the SEC’s objective of ensuring that all compensation is disclosed, a new column would expand and combine the “current other annual compensation” and “all other compensation” to disclose all compensation not included in another column. This column would serve as a “catch-all” for any amounts of compensation not properly reportable in the other columns in the table. The SEC has purposefully designed this column to be broad in scope in order to prevent the omission of amounts of compensation that technically might fall outside the categories covered elsewhere in the table.

The only exception to the requirement that “all” other compensation be included in this column is with respect to perquisites provided to a named executive officer. Generally, the total cost of all perquisites provided to a named executive officer must be disclosed in this column, unless the total cost is less than \$10,000 (the current threshold is the lesser of \$50,000 or 10% of the total of annual salary and bonus). If the aggregate cost of the perquisites provided to the officer is over \$10,000 and thus included in the

column, then all of the perquisites provided to the officer must be identified in a footnote. In addition, the dollar value of any one perquisite would be disclosed if it exceeds the greater of \$25,000 or 10% of total perquisites and other personal benefits provided to the officer.

In addition, under the proposal, any single item of compensation (other than perquisites¹) disclosed in this All Other Compensation column with a value in excess of \$10,000 would need to be separately identified by type and quantified in a footnote. The proposal discusses two specific items that would be disclosed in this column that differ from the current instructions: earnings on deferred compensation that is not tax-qualified² and the aggregate increase over the previous fiscal year in the actuarial value of each named executive officer's defined benefit retirement plans.

The proposed rules list a number of other items that would need to be disclosed in this column, including:

- information (including costs) regarding relocation plans, even if generally available to all salaried employees;
- amounts paid or accrued during the year in connection with any termination of employment or a change in control (post-employment compensation that is payable in the future is disclosed separately, as discussed below);
- company contributions to defined contribution plans;
- the dollar value of any insurance premiums paid by the company with respect to life insurance for the benefit of a named executive officer (the current requirement to disclose the value of remaining premiums on term life insurance in which the named executive has an interest in the cash surrender value would be eliminated);
- tax gross-ups or other tax reimbursements (even on perquisites that are themselves exempt from disclosure); and
- compensation cost computed in accordance with FAS 123(R) for any purchases of company stock at a discount, unless the discount is available generally to all security holders or all salaried employees.

New supplemental tables

The Summary Compensation Table would be followed by two supplemental tables that would report information relating to grants of performance-based awards and equity-based compensation awards.

¹ As stated in the paragraph above, all perquisites included in the All Other Compensation column must be identified in a footnote.

² Currently, these earnings are reflected in the table only if they are above-market or preferential.

Grants of performance-based awards table. This table would set forth details of incentive plan awards of non-stock grants, options, restricted stock, phantom stock and units or other rights if they were performance-based. An award would be considered performance-based if it had a performance condition or market condition as defined in FAS 123(R). The table would show the terms of grants made during the last year, including estimated future payouts for threshold, target and maximum performance.

Grants of all other equity awards table. The second supplemental table would show details of equity-based compensation awards that are not performance-based. These awards would consist of stock options, restricted stock, restricted stock units and similar awards under which future value or payment is based on the price of the company's stock rather than performance criteria.

Other new tables

Equity award tables. Two new equity award tables would be required, replacing the current tables related to stock options and SARs, and expanding them to include non-option awards (e.g., restricted stock and performance awards). One table would set forth the outstanding equity awards held by named executive officers at the end of the year, including the number of unexercised stock options and SARs, the intrinsic value of in-the-money stock options and SARs and the number of unvested shares of stock and restricted stock units and their market value. The other table would show the amounts realized by executive officers during the year from the exercise of stock options and the vesting of restricted stock and other equity awards, along with the grant date fair value of that portion of the award as previously reported in the Summary Compensation Table.

Retirement benefits. The current pension plan table would be replaced by a new table that would show the annual retirement benefits of named executive officers under defined benefit retirement plans (both tax-qualified and non-qualified). The table would include for each named executive officer, the name of the plan in which the named executive officer participates, the years of credited service, the plan's normal retirement age and early retirement age, and the estimated annual retirement benefit payable at normal retirement age and early retirement age. The table would be followed by a narrative description of related material factors which might include the lump sum distribution payable at the end of the last fiscal year, what pay elements are considered in formulating the benefit, and the company's policy on granting additional years of credited service.

Deferred compensation. Another new table would disclose information relating to non-qualified defined contribution retirement plans and other deferred compensation plans. Included in the table would be contributions during the year by the named executive officers and the company, earnings and withdrawals during the year, and the aggregate balance credited to each named executive officer at the end of the year.

Termination and change in control payments

Under the proposed rules, potential post-employment compensation that is or may become payable upon an actual or constructive termination of employment or a change in control of the company would be required to be disclosed separately in narrative format. The current \$100,000 threshold for disclosure for post-employment payable compensation would be eliminated and the current disclosure rules would be expanded to include disclosure of the following:

- the specific circumstances that would trigger termination or change-in-control payments;
- the estimated payments and benefits that would be provided in each circumstance, including the form and the source of such payments;
- any specific factors used to determine the payment and benefit levels;
- any material conditions on receipt of payments, including the type and duration of any restrictive covenants and provisions regarding the waiver and breach of these covenants;
- the amounts of any related tax gross-ups; and
- any other material factors necessary for understanding the termination and change-in-control arrangements.

Quantitative disclosure regarding estimated payments and benefits is required even where uncertainties exist as to the amounts that may be payable. In the case of any uncertainty, the company would be required to make reasonable estimates regarding the amount of payments and benefits and to disclose the material assumptions underlying such estimates.

A number of variables need to be taken into account to calculate the value of certain future payments. For example, the valuation of tax gross-up provisions require assumptions about future tax rates, the value of future benefits and how certain aspects of the excess parachute tax rules would apply to those benefits. The SEC is likely to receive comments asking for some relief from reporting the value of payments which depend on numerous uncertain variables. However, it is not clear whether the SEC will be receptive to providing such special relief.

Director compensation

A new director compensation table, similar to the Summary Compensation Table for named executive officers, would be required to be included in the proxy. The table would only show information about each director's compensation for the prior year (not the prior three years as required for named executive officers). The salary and bonus columns would be replaced by a column showing all director fees earned or paid in cash. The remainder of the table would be similar, with separate columns for stock awards, option awards, non-stock incentive plan compensation, all other compensation (which

would include the cost of awards under director legacy or charitable award programs) and total compensation (which would be the first column).

Form 8-K disclosure of executive compensation arrangements

The proposal would significantly reduce the current disclosure of executive compensation arrangements on Form 8-K. As revised, only material employment arrangements for named executive officers and directors and material amendments would need to be disclosed on Form 8-K. Individual grants and awards would not need to be disclosed on Form 8-K if they are consistent with previously disclosed compensation plans.

Related-party transactions

The proposal would streamline the disclosure of related-party transactions, make the disclosure principle-based, and increase the threshold for reporting such transactions to \$120,000. The SEC notes that the proposal may require the disclosure of business relationships that are not required to be disclosed under the current rules. This is the case because the proposal would remove the specific standards applicable to business relationships and subject business relationships to the general \$120,000 test. However, the SEC clarifies in the proposal that the \$120,000 test must be combined with a materiality analysis of the interest of the related-party in the transaction. In light of this guidance, we do not expect that the proposal will generally expand the existing disclosure of business relationships. The proposal also would require the disclosure of a company's policies and procedures for approving related-party transactions and as to whether any reportable transaction was not so approved.

Miscellaneous

Other items included in the proposed rules are:

- A requirement that all executive and director compensation disclosure be provided in "plain English;"
- Disclosure of the number of shares of company stock pledged by named executive officers, directors and director nominees by footnote to the beneficial ownership table;
- Disclosure relating to whether each director and nominee for director is independent; and
- Disclosure about the compensation committee, including the scope of its authority, the role of executive officers and compensation consultants in determining or recommending the amount or form of executive and director compensation, and the identity, nature and scope of assignments of compensation consultants.

Interpretive Guidance on Perks Effective Now

Current rules do not define what constitutes a “perquisite.” However, the SEC has taken the opportunity in these proposed rules to provide guidance to companies determining what constitutes a perquisite. *This guidance is currently applicable, and the SEC staff has confirmed that the guidance should be applied to current filings.*

In determining whether an item is a perquisite or other personal benefit, companies must consider two factors. If an item is not integrally and directly related to the performance of an executive’s duties, it is perquisite. Also, if an item confers a direct or indirect benefit that has a personal aspect, regardless of whether it is provided for a business reason or for the convenience of the company, unless it is generally available on a nondiscriminatory basis to all employees, it is a perquisite.

As is currently the rule, the aggregate incremental cost is the proper measure of the value of perquisites and other personal benefits. However, the SEC makes it very clear that the amount attributed to income for federal tax purposes is not the incremental cost for proxy disclosure purposes. Therefore, the cost of airplane travel should not be based on the amount imputed as income under the Standard Industry Fair Level (SIFL) rules.

Examples of perquisites or personal benefits include, but are not limited to: 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 or other living expenses, security provided at a personal residence or during personal travel, commuting expenses, and discounts on the company’s products or services not generally available to other employees on a nondiscriminatory basis.

Examples of items that would not be perquisites or other personal benefits would include, among other things, travel to and from business meetings, other business travel, business entertainment, security during business travel, and itemized expense accounts, the use of which is limited to business purposes.

Things to Do Now

In completing its proxy statement for its 2006 annual meeting, each company should revisit how it has characterized items that have a mixed business and personal purpose, and determine whether additional amounts need to be disclosed in the Summary Compensation Table as perquisites based on the SEC’s now formally stated standard for determining what is a perquisite. Additionally, in light of the SEC’s statement that these proposed rules confirm that all items of compensation must be disclosed, issuers will want to confirm that any items of compensation that they do not intend to disclose in the

current Summary Compensation Table are permitted to be excluded by the express terms of the current rules.

Companies will also want to start now to evaluate their compensation policies, procedures and structures in light of these new requirements. In particular, each company should consider:

- drafting the CD&A well advance of the 2007 proxy season to have sufficient time to gather necessary information and involve necessary constituencies;
- drafting the CD&A well in advance of the 2007 proxy season to allow the Compensation Committee to evaluate the disclosures and make any desired changes in its processes;
- how it will document its compensation decision-making processes in order to support certifications by the CEO and CFO, to permit due diligence and opinion delivery in connection with securities offerings, and to provide a roadmap for drafting the CD&A;
- adding a “total compensation” column or other columns from the proposals to the Summary Compensation Table for its 2006 proxy – the SEC has indicated that it would be permissible as long as the currently required columns in the table are not changed;
- adding a director compensation table similar to the one in the proposed rules to its 2006 proxy;
- converting its compensation disclosure in 2006 to “plain English;”
- updating their record keeping systems in order to track all perquisites, even those of low value, because once the \$10,000 threshold is reached, all perquisites will have to be identified under the new rules;
- adopting written policies and procedures regarding the approval of related party transactions if not currently in place; and
- updating their D&O questionnaires to capture any of the new disclosures that are not generated internally.

SEC Release

A copy of the proposed rule release is available on the SEC’s website at <http://www.sec.gov/rules/proposed/33-8655.pdf>

NASHVILLE *Downtown*
AmSouth Center
315 Deaderick St. · Ste. 2700
Nashville, TN 37238-3001
(615) 742-6200

KNOXVILLE
1700 Riverview Tower
900 S. Gay St.
Knoxville, TN 37902
(865) 521-6200

MEMPHIS
The Tower at Peabody Place
100 Peabody Place · Ste. 900
Memphis, TN 38103-3672
(901) 543-5900

NASHVILLE *Music Row*
29 Music Square East
Nashville, TN 37203-4322
(615) 255-6161