

## SEC Adopts Rules on the Disclosure of Executive Compensation

At an open meeting on July 26, 2006, the Securities and Exchange Commission (SEC) unanimously voted to adopt final rules on executive compensation disclosure, related person transactions, and other corporate governance matters. The final rules are largely similar to the proposed disclosure rules issued in January, which were described in our [Client Alert](#) dated January 20, 2006. Ropes & Gray will issue a Client Alert describing the final rules when they are published. In the interim, this Client Alert summarizes the principal differences between the proposed and final rules, as described at the SEC's open meeting.

### Disclosure of stock option grant practices

As expected in light of the current tumult over option backdating, the final rules will require companies to provide more information about stock option grants. Specifically, the final rules will require disclosure about the timing of option grants in coordination with the release of material nonpublic information and the selection of exercise prices that differ from the underlying stock's price on the grant date. Companies will be required to disclose in a table:

- The grant date fair value;
- The FAS 123R grant date;
- The closing market price on the grant date if it is greater than the exercise price of the award; and
- The date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date.

If a company selects an exercise price other than the closing market price on the grant date, the final rules will require a description of the methodology for determining the exercise price. In addition, the final rules will require companies to include a narrative disclosure of option grant practices in the new Compensation Discussion and Analysis section (CD&A).

At the open meeting, several Commissioners emphasized that the new disclosure requirements do not indicate the SEC's preference for any particular practice related to stock option grants. Rather, the final rules are intended to improve the information available to shareholders about a company's stock option grant practices. However, Commissioner Atkins warned that companies that deliberately mischaracterize stock option grant practices or falsify documents will continue to be subject to enforcement actions.

### Individuals for whom compensation data must be disclosed

#### *Named executive officers*

The SEC's final rules will alter slightly the method by which companies must determine their named executive officers. As in the proposed rules, named executive officers will include the chief executive officer (CEO), the chief financial officer (CFO), and the three most highly-compensated executives other than the CEO and CFO. Although the determination of which executives are the most highly-compensated will be based on total compensation, as proposed,

the final rules will exclude the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation for the purpose of determining the named executive officers. These amounts will still be included in the table in a separate column, but will not determine whose information gets reported.

#### *Non-executive employees*

The final rules made some last minute changes to the so-called “Katie Couric” clause, and the SEC is reproposing it. The proposed rules contained a provision requiring disclosure of the total compensation and job description of up to three non-executive officers who received higher compensation than any named executive officer. The new proposal, which would apply only to large accelerated filers, would limit the pool of employees to whom the non-executive disclosure requirements would apply to those who have responsibility for significant policy decisions within the parent company, a significant subsidiary, or a principal business unit, division, or function.

### **Supplement to CD&A**

In the proposed rules, the CD&A was slated to replace the Compensation Committee report and performance graph. Although the CD&A will replace the current Compensation Committee report and will be “filed” not “furnished,” the final rules will add a new Compensation Committee report to supplement the CD&A. In the new report, the compensation committee will be required to disclose whether it reviewed and discussed the CD&A with management and recommended to the board that the CD&A be included in the company’s Form 10-K or proxy statement. Additionally, the final rules will retain the performance graph, although it will no longer be included as part of the executive compensation disclosure requirements. Instead, companies will include the performance graph in the glossy annual reports that accompany proxy statements.

### **Post-employment payments and benefits**

#### *Disclosure of nonqualified deferred compensation*

The proposed rules would have departed from current rules by requiring companies to disclose in the Summary Compensation Table all earnings on nonqualified deferred compensation. The final rules will return to the current practice of requiring companies to disclose in the Summary Compensation Table only above-market or preferential earnings on nonqualified deferred compensation. The final rules also require, however, that companies disclose all earnings on nonqualified deferred compensation in a separate Nonqualified Deferred Compensation Table.

#### *Disclosure of pension benefits*

The final rules will simplify disclosure of pension benefits by requiring companies to disclose the actuarial present value of each named executive officer’s accumulated pension benefits, assuming normal retirement age and no increase in compensation.

### **Severance and change of control benefits**

Like the proposed rules, the final rules will require narrative disclosure of the estimated value of severance and change of control benefits. However, the final rules specify that companies must assume that the triggering event took place on the last business day of the company’s last fiscal year and that the price per share was the closing market price for the company’s stock on that date. A range of values, rather than one number, will be permitted.

## Compliance Dates

The majority of the disclosure requirements in the final rules will take effect for fiscal years ending on or after December 15, 2006 and thus will apply to most companies' 2007 proxy statements and annual reports on Form 10-K.

## Contact Information

If you have any questions or would like to learn more about these rules, please contact your usual legal advisor at Ropes & Gray LLP, or any of the individuals listed below involved in the preparation of this Client Alert.

### **Keith F. Higgins**

617-951-7386

[keith.higgins@ropesgray.com](mailto:keith.higgins@ropesgray.com)

### **Julie H. Jones**

617-951-7294

[julie.jones@ropesgray.com](mailto:julie.jones@ropesgray.com)

### **Christopher A. Klem**

617-951-7410

[christopher.klem@ropesgray.com](mailto:christopher.klem@ropesgray.com)

### **Eva S. Wilkinson**

202-508-4738

[eva.wilkinson@ropesgray.com](mailto:eva.wilkinson@ropesgray.com)