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Client**Advisory**

SEC Announces Modification of Executive Compensation Rules

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On Friday, December 22, 2006, the Securities and Exchange Commission issued a release adopting, as interim final rules, amendments to its executive and director compensation rules adopted just five months earlier.

The stated reason for the amendments was "to align the reporting of equity awards ... to the amounts disclosed in the financial statements under FAS 123R." The adoption of the amendments as interim final rules meant that their provisions took effect immediately upon publication in the *Federal Register*, which occurred on December 29, 2006. This was done in order to have the applicability of the amendments match that of the original rules adopted in July 2006. The Commission's release solicits comments on the amendments during the 30 days following publication, and promises to make changes to the amendments if any are found to be necessary.

Changes to Disclosure Tables

The major changes effected by the amendments appear in the Summary Compensation Table, the Grants of Plan-Based Awards table and the Directors Compensation Table.

Summary Compensation Table – Basic Change

In the Summary Compensation Table (SCT), columns (d) and (e), Stock Awards and Option Awards, originally required disclosure for each of the named executive officers of the aggregate grant date fair market value of all awards received by each in the fiscal year, computed in accordance with FAS 123R. The fact that all or some portion of an award might not vest or become exercisable until some future time, or might be subject to some performance-related condition, did not reduce the amount to be disclosed.

The amendments to the SCT change this. The amount to be reported in columns (d) and (e) is now the compensation cost recognized in the relevant fiscal year by the company for each named executive officer (NEO) in accordance with FAS 123R. Very briefly, FAS 123R requires the compensation cost of stock-based awards to be recognized as conditions to the award are satisfied over the "requisite service period."[1]

Under the amended rules, the amounts reported in columns (d) and (e) of the SCT will include compensation cost of stock and option awards recognized in the current fiscal year on account of both current- and prior-year awards.

Clients who have already made a preliminary determination, based on the original rules, as to who are the three highest paid executive officers other than the CEO and CFO, may need to recalculate based on total compensation as reported in the revised SCT.

Summary Compensation Tables – Additional changes

- **Valuation Assumptions Footnote.** In the July release, the valuation assumptions footnote was required to include a cross-reference to a discussion of award valuation assumptions appearing in financial statements or footnotes thereto, or in the MD&A. The amendment adds a requirement that the footnote disclosure include disclosure of awards forfeited during the fiscal year.

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[1] Defined in FAS 123R as the period over which an employee is required to provide services in exchange for a share-based payment. Compensation cost includes both the amount recorded as expense on the income statement and earned compensation that has been capitalized on the balance sheet (such as by the issuance of equity in lieu of cash salary or bonus.)

- **Forgone Salary/Bonus.** Some companies have programs allowing an executive to forego a portion of cash compensation in favor of stock, equity-based or other non-cash compensation. Under the original rules, the amount of salary or bonus forgone in this manner did not have to be included in the SCT, although the resulting non-cash compensation did. The amendment now requires (on the basis that reporting the non-cash substitute in the Stock or Option Awards SCT column is inconsistent with the original terms of the award that would have paid cash) that the cash amount forgone must nonetheless be included in the salary or bonus column as appropriate, with a footnote that (1) discloses the receipt of the non-cash compensation in lieu of the cash, and (2) cross-references to the Grant of Plan-Based Awards Table where the non-cash award must be disclosed.

- **Cash-Based Settlement Awards.** These include awards whose value is measured by equity but settled in cash (e.g., an SAR) and awards having repurchase features or other features the effect of which is to avoid the employee bearing the risks and rewards normally associated with equity ownership. Under FAS 123R, the compensation cost of cash-based settlement awards is re-measured at each financial statement date. Under the new rules, the resulting incremental compensation cost changes will be picked up in the SCT. A negative change will reduce total compensation as reported in the SCT.

- **Dividends**. The dollar value of any dividends (or other earnings) paid in the fiscal year on stock or option awards must be disclosed in the "All Other Compensation" column of the SCT, unless it was factored in the grant date fair value of the award itself.

- **Forfeitures.** Under FAS 123R, a company is required to estimate, as of the grant date of options, the number of awards that ultimately will be earned. In this respect the amendment departs from FAS 123R; the compensation cost reflected in the tables under Item 402 of Regulation S-K will not include an estimate of forfeitures. The disclosed amount will assume, in effect, that each NEO will perform whatever services are required in order for an award to vest fully. If this assumption turns out to be incorrect, i.e., some part of the award is forfeited, the forfeited amount is to be deducted from compensation in the SCT for the period in which the forfeiture occurs (and disclosed in the valuation assumptions footnote, as noted above.) So, for example, the SCT-reported total compensation of an executive whose employment terminates, causing forfeiture of substantial stock and option awards, would be substantially reduced.

- **Performance-Based Vesting.** The compensation cost of awards containing a performance-based vesting condition[2] will only be disclosed in the SCT if it is probable that the performance condition will be achieved. If this is not the case when the award is granted but becomes so in a later period, the SCT for that period will disclose the compensation cost of the award on a "catch-up" basis, based on the periods since grant over which services were rendered. If the reverse occurs (probable when granted, becoming improbable later), the previously disclosed compensation cost will be reversed in the period when achievement of the performance-based condition becomes improbable.

- **Non-Equity Awards.** Noting that there is no accepted standard for valuing a non-equity award (such as a cash incentive award) at grant date, the amendment provides that those awards are to be disclosed in the SCT in the period when the award-specified performance criteria are met and the award is earned, whether or not the NEO actually receives payment of the award in that period.

- **Negative Compensation.** The adopting release notes the possibility that if (for example) the value of awards forfeited in a given year exceeds the value of those granted, the net value will be negative and will reduce total compensation, a proper result.

- **Retirement.** The adopting release also notes that under FAS 123R, an award granted to a retirement-eligible employee that he or she can retain through retirement is not deemed to be subject to a minimum-service requirement, because he or she can retire and get the award without performing any services. In that case, the full grant date fair value of the award will appear in the SCT in the year of grant, just as was the case prior to the amendment.

Grant of Plan-Based Awards Table

A column titled "Grant Date Fair Value of Stock and Option Awards" is added at the right-hand side of the Grant of Plan-Based Awards Table (PBAT.) This column lists the full fair market value of each plan-based award granted to an NEO during the fiscal year. Each award to each NEO must be separately listed. The aggregate of the listings for each NEO therefore produces the same information as formerly appeared in columns (d) and (e) of the SCT. The difference is that the

2 FAS 123R defines a performance condition as "a condition affecting the vesting, exercisability, exercise price or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee's rendering services for a specified ... period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations ...." The amendment gives the following as examples: Achieving a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an IPO or other financing event, a change of control.

aggregate number is no longer included as part of the "total" compensation in the SCT to the extent that the compensation cost of any of the awards will be recognized in a future period.[3]

The PBAT changes also require disclosure relating to repricing or material modification of options, SARs and similar instruments that resemble options. The incremental compensation cost amount resulting from the repricing or modification, computed in accordance with FAS 123R, must be disclosed. This requirement is inapplicable to modifications that equalize the fair value of an award before and after the modification, such as one made under an anti-dilution provision. It also does not apply to repricings mandated by a pre-existing formula or mechanism in the plan or award, which would have been reflected in computing and disclosing the grant date fair value of the award.

Director Compensation Table

Changes to the Director Compensation Table (DCT) mirror some of the changes to the SCT:

- The Stock and Option columns of the DCT are revised to require reporting of the compensation cost of director stock and option awards recognized by the company in the relevant fiscal year in accordance with FAS 123R.
- The full grant date fair value of each equity award, computed in accordance with FAS 123R, must be disclosed in a footnote to the DCT (equivalent to the disclosure in the newly-added "Grant Date Fair Value of Stock and Option Awards" column in the PBAT.)
- Dividends or other earnings on stock or option awards must be disclosed in the "All Other Compensation" column of the DCT (unless factored in the grant date fair value of the award). Non-equity incentive plan awards and earnings, and earnings on stock and option awards, are reported in a footnote and not in the "All Other Compensation" column.[4]
- Repricing or material modification of options, SARs and similar instruments that resemble options must be disclosed in a footnote to the DCT.

Text of Release

The full text of the release as published in the Federal Register can be viewed at **http://www.sec.gov/rules/final/2006/33-8765fr.pdf**.

We Can Help

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3. Grant date fair value information is not required for small-business issuers, since Item 402 of Regulation S-B does not include a PBAT. Similar information is required in a footnote to the SCT under Item 402(c) of Regulation S-B.
4. Instruction to Item 402(k). This instruction incorporates into the DCT by reference many of the instructions to the SCT, including those relating to forgone compensation, repriced or modified cash settlement awards, performance-based awards, and non-equity incentive awards and earnings.

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