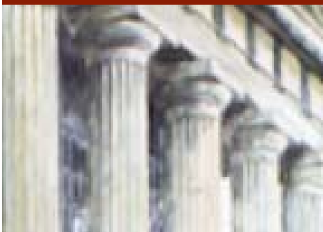

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LEGAL TOPICS

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# 2ND YEAR OF ENHANCED EXECUTIVE AND DIRECTOR COMPENSATION DISCLOSURE REQUIREMENTS

*by Iain MacSween*

In 2006, the Securities and Exchange Commission ("SEC") significantly increased executive and director compensation disclosure requirements. Following the 2007 annual reporting and proxy season, the SEC issued interpretive guidance on executive compensation disclosures (available at http://www.sec.gov/divisions/corpfin/guidance/execcomp402interp.htm) (the "August Guidance") and carried out a review of executive compensation and related disclosure of 350 public companies. In October, 2007, the SEC issued its report entitled, "Staff Observations in the Review of Executive Compensation Disclosure" (available at http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm) (the "October Report"). Both the August Guidance and the October Report are recommended reading for employees charged with leading the preparation of his or her company's proxy and annual reporting documents.

## August Guidance

The August Guidance consists of a series of practical questions and answers, followed by a series of interpretive responses regarding particular situations.

As well as providing useful guidance on some of the more technical aspects of the new tables and footnotes, the August Guidance includes the following:

- ***New named executive officer in 2007*** – if a person who was not a named executive officer in fiscal year 2006 became a named executive officer in fiscal year 2007, his or her compensation information need only be disclosed in the Summary Compensation Table for the year in which he or she qualifies as a named executive officer; i.e., 2007 and not 2006. (Question 4.01).

- ***Reimbursed perquisites*** – if a perquisite is "fully reimbursed" by a named executive officer to the company, then there is no requirement to disclose the perquisite. However, the concept of "fully reimbursed" is not limited to the incremental cost to the company. For instance, an executive officer would only be deemed to have "fully reimbursed" the company for a meal at a country club if he or she reimbursed not only the cost of the meal, but also a proportional amount of the country club dues paid by the company. (Question 4.07).

- ***Directors serving for only part of the reporting year*** – director compensation disclosure is required in the Director Compensation Table for a director, even though he or she may only have served as a director for part of the reporting year, or will not

stand for re-election the following year. (Questions 12.01 and 12.02).

- ***Merger during reporting year*** – following a merger among operating companies, there is no concept of "successor" compensation. Therefore, the surviving company in the merger need not report on compensation paid by predecessor corporations that disappeared in the merger. Moreover, income paid by such predecessor companies need not be counted in computing whether an individual qualifies as a named executive officer of the surviving corporation. (Item 4.02, Question 1.02).

**October Report**

The October Report focused on a number of items, including the following:

- ***How and why*** – the SEC is encouraging improved disclosure on how and why executive compensation is arrived at, rather than simply a description of the compensation philosophies and decision mechanics. The focus should be on helping the reader understand the basis and the context for granting different types and amounts of executive compensation to named executive officers; *e.g.*, levels of responsibility, years of service, experience, performance targets, etc. During the 2007 proxy season, the SEC asked a significant number of companies to re-focus their Compensation Discussion and Analysis presentations on the substance of their compensation decisions and to disclose how they analyzed information and why their analyses resulted in the compensation paid. For example, where a company provided a lengthy discussion about its compensation philosophies, the SEC suggested that it improve its Compensation Discussion and Analysis by explaining how and why its philosophies actually resulted in the numbers it presented in the required tables.

- ***Format*** – the Compensation Discussion and Analysis is meant to be a narrative overview at the beginning of the compensation disclosure, putting into perspective the numbers in the tables that follow. The SEC has indicated that where companies have placed compensation tables before the Compensation Discussion and Analysis, it has asked such companies to relocate those tables to follow the Compensation Discussion and Analysis.

- ***Additional presentations*** – approximately two-thirds of those companies that were reviewed by the SEC included additional charts, tables and graphs not required by the revised rules. The SEC commented that, for the most part, it found these additional presentations to be helpful. For example, a number of companies voluntarily included a table in which they presented information regarding potential payments upon termination or change in control. Note however that where companies presented alternative Summary Compensation Tables, the SEC asked those companies to explain the differences between compensation amounts presented in those tables and compensation amounts presented in the required tables.

- ***Benchmarks*** – when a company discloses that it has used benchmarking, Item 402 requires it "to identify the benchmark and, if applicable, its components (including component companies)." Accordingly, where a company indicates that it benchmarked compensation to its peers, but did not identify the peers or provide sufficient details concerning the benchmarking it used, the SEC

asked it to identify the companies to which it compared itself as well as the compensation components it used in that comparison. Also, if a company exercises discretion in applying benchmarks, it should provide detail regarding whether and how it exercised that discretion.

- *Change in control and termination arrangements* – the SEC asked a number of companies to disclose why they structured the material terms and payment provisions in their change of control and termination arrangements as they did. They also asked companies to discuss how potential payments and benefits under these arrangements may have influenced their decisions regarding other compensation elements.

- *Corporate governance* – in a number of instances the SEC sought additional information on which individuals and which procedures it relied upon to consider and determine the executive and director compensation. For instance, where a company indicated that its principal executive officer had a role in the compensation decision-making process, the SEC asked it to describe his or her role. Similarly, companies are encouraged to disclose the role compensation consultants played in the decision-making process, including the nature and scope of a consultant's assignment and material instructions given to it by the company.

Note also that this year, companies will need to provide a minimum of two years of annual compensation in the Summary Compensation Table. Accordingly, it may be appropriate to provide additional analysis and explanation of any material changes between these two years.

**eProxy Rules**

During 2007, the SEC adopted amendments to its proxy rules requiring reporting companies to furnish proxy materials to shareholders over the Internet. Large accelerated filers, except mutual funds, must comply, beginning January 1, 2008. All other companies, including mutual funds, must comply beginning January 1, 2009. For a discussion of these new rules see the Memo entitled "Mandatory Electronic Posting of Proxy Materials" by my colleague, Jean C. Brooks.

**Smaller Reporting Company Regulatory Relief and Simplification**

Beginning February 4, 2008 the SEC is phasing out the category of filers known as "small business issuers" and the corresponding Regulation S-B and "SB" reporting documents, and introducing the new category, "smaller reporting companies." As a result, all filers, large and small, will use the same integrated disclosure system currently used by larger filers, which integrated system provides scaled disclosure requirements for "smaller reporting companies," similar to the current Regulation S-B system.

While the "small business issuer" designation will be eliminated, Regulation S-B and the related "SB" forms will continue to be available on a transitional basis until March 15, 2009 and October 31, 2008, respectively. Accordingly, many small business issuers with December 31 fiscal year-ends will file their annual reports on Form 10-KSB this 2008 reporting season and will continue to file Forms 10-QSB throughout 2008, moving to filing their annual reports on Form 10-K and quarterly reports on 10-Q beginning in 2009.

- *"Smaller Reporting Company"* – this designation will generally apply to companies having less than $75 million in public common equity float (*i.e.*, the company's stock price multiplied by the number of outstanding shares held by non-affiliates). This is calculated as of the last business day of a company's most recently concluded second fiscal quarter, *i.e.*, for companies with a December 31 fiscal year-end, this will initially be calculated as of June 30, 2007 and annually thereafter. Companies that are unable to calculate their public common equity float will be eligible as "smaller reporting companies" based on whether they had annual revenues of less than $50 million in the last fiscal year. This replaces the previous "small business issuer" eligibility requirements that companies have both less than $25 million in public common equity float and less than $25 million in annual revenues. The result is that a number of larger companies (non-accelerated filers and possibly some accelerated-filers) will qualify as "smaller reporting companies" and become entitled to apply the scaled disclosure requirements.

- ***Transition for current small business issuers*** – existing small business issuers are given the option to file their next annual report for a fiscal year ending on or after December 15, 2007 on either Form 10-KSB or Form 10-K. Thereafter, a small business issuer may continue to file its periodic reports using Regulation S-B and the "SB" forms until its next annual report is filed. After a small business issuer files that next annual report, subsequent periodic reports must be filed on a form that does not have the "SB" designation.

- ***Entering and exiting "smaller reporting company" status* – the** rules for entering and exiting "smaller reporting company" status have been simplified to provide that once a "smaller reporting company" has exited the scaled disclosure system (effective the fiscal year after their public float rose above $75 million as of the last business day of their second fiscal quarter), it will be entitled to re-enter the scaled disclosure system again if its public float falls below $50 million on the last business day of its second fiscal quarter. In such an example, the company would be able to use scaled disclosure again beginning with Form 10-Q for the same second fiscal quarter in which the company determined its eligibility for "smaller reporting company" status.

- *"A la carte" disclosure* – companies that qualify as "smaller reporting companies," although not required to provide the full disclosure under Regulation S-K may choose on an item-by-item basis to comply with either the scaled disclosure and financial reporting requirements made available in Regulation S-K for "smaller reporting companies" or the full disclosure requirements for larger companies in Regulation S-K, when the requirements for larger companies are more rigorous.

**Compliance with Sarbanes-Oxley Section 404 for Smaller Companies**

For the first time this year, non-accelerated filers filing their annual report on Form 10-K for a fiscal year-ending on or after December 15, 2007 (*e.g.*, December 31, fiscal year-end filers) are required to include a report by management assessing the effectiveness of the company's internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act and Rules 13A-15(c) and 15D-15(c) under the Securities Exchange Act of 1934, as

amended. In addition, these filers will also have to revise their CEO and CFO certifications, however they will not be required to file an auditor's attestation of management's report until they file their annual report on Form 10-K for the fiscal year-ending on or after December 15, 2008 (*e.g.*, year-end December 31, 2008).

**Reduction in Rule 144 Holding Period**

After February 15, 2008, the Rule 144 holding periods for sales of restricted securities will be reduced as follows:

- *Non-affiliates of reporting companies* – six-month holding period for sales of restricted securities, subject to compliance with current public reporting requirements. After a one-year holding period, non-affiliates will be able to freely sell restricted securities without being subject to any Rule 144 requirements. In addition, non-affiliates of reporting companies are no longer required to file Forms 144 reporting sales, nor are they subject to volume limitations.

- *Affiliates of reporting companies* – as with non-affiliates, there may be no sales of restricted securities during the initial six-month holding period. After the six-month holding period, affiliates may sell restricted securities subject to compliance with current public reporting requirements, volume limitations, the requirement to file a Form 144 and certain other "manner-of-sale" requirements. Note that the thresholds for filing Forms 144 have been raised from 500 shares or $10,000, to 5,000 or $50,000.

- *Non-affiliates and affiliates of non-reporting companies* – both affiliates and non-affiliates of non-reporting companies will be subject to a one-year holding period. After the one-year holding period, non-affiliates may publicly sell restricted securities without complying with any other Rule 144 requirements, whereas affiliates may sell restricted securities subject to compliance with current public reporting requirements, volume limitations, the requirement to file a Form 144 and other "manner-of-sale" requirements.

**Direct Registration System**

The NYSE, AMEX and NASDAQ exchanges have each implemented rules requiring listed companies to be eligible to participate in the Direct Registration System ("DRS"), effective January 1, 2008. Note that this requirement does not apply to companies "quoted" on the Over-The-Counter-Bulletin-Board ("OTC BB") or the "Pink Sheets". DRS is a system that dispenses with the need for physical share certificates, instead enabling shareholders to be registered on the books of the transfer agent. In some cases companies may be required to amend their Bylaws to enable them to comply.

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If you have any questions about this client advisory or if you have any questions about how the changes will affect you, please contact Iain MacSween at (336) 271-3192, or one of the other Brooks Pierce securities attorneys in the following list.

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