Corporate Alert: SEC Amends New Executive Compensation Disclosure Rules

December 28, 2006

On December 22, 2006, without prior notice, the Securities and Exchange Commission adopted amendments to its recently revised rules on executive and director compensation disclosure requirements. For many companies the amendments will result in significant changes in the disclosure of stock options and other stock-based awards from that which would have been made under the new rules as originally adopted. The amendments will be effective upon their publication in the Federal Register.[1]

Compliance with the previously adopted new disclosure rules (as they will be amended as soon as the SEC's new amendments become effective) is required in annual reports on Form 10-K for fiscal years ending on or after December 15, 2006 and in proxy statements and registration statements that are required to include executive compensation and related disclosure for fiscal years ending on or after December 15, 2006.[2]

The stated purpose of the amendments is to conform the disclosure of stock and option awards under the SEC executive and director compensation disclosure rules more closely with the accounting rules under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004) (FAS 123R) in order to give investors a better idea of the compensation earned by an executive or director during a particular fiscal year.

The principal changes contained in the amendments, and some of their consequences, are the following:

- The amounts disclosed for stock and option awards in the summary compensation table and director compensation table will no longer be their aggregate grant date fair value computed

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1 Although the SEC, as permitted by the statute governing agency rulemaking, found, "for good cause," both that notice and solicitation of public comment on the amendments are "impracticable, unnecessary and contrary to the public interest" and that immediate effectiveness is appropriate, the amendments are technically "interim final rules" and the SEC will consider any comments received during the 30-day period following publication in the Federal Register and revise the amendments "if necessary."

2 For additional information regarding the SEC's recently adopted new rules concerning executive compensation and other related disclosure, please refer to our memorandum dated August 28, 2006 entitled "*SEC Adopts Final Rules Concerning Executive Compensation and Related Disclosure*" and our alert dated September 21, 2006 entitled "*Corporate Alert: Changes to Form 8-K Relating to Executive Compensation Disclosure,*" both of which are available on our website: www.simpsonthacher.com.

in accordance with FAS 123R and reported in the fiscal year of grant. Instead, the amounts reported in the summary compensation table and director compensation table will be the amounts recognized for financial statement purposes with respect to the fiscal year in accordance with FAS 123R, except that

- companies must disregard, for the table amounts, the estimate of forfeitures related to service-based vesting conditions; and
- as a transitional matter, companies are required to use the FAS 123R "modified prospective transition method" in calculating the annual expense relating to awards granted prior to the companies' adoption of FAS 123R, regardless of whether they have adopted that transition method for financial statement purposes.

The effect of this change is to require reporting of the compensation cost of stock-based awards over the period during which an executive is required to provide service in exchange for the award as provided in FAS 123R (generally the vesting period), rather than reporting the full grant date fair value in the fiscal year of grant.[3]

- The aggregate grant date fair value will, however, now be reported, on a grant-by-grant basis, in a new column in the grants of plan-based awards table for named executive officers and in a footnote to the director compensation table for directors.
- These changes may affect the individuals who are "named executive officers" for purposes of executive compensation disclosure, since they will, for many individuals, change the amount of total compensation upon which the named executive officers (other than the CEO and CFO) are determined.
- As a result of tying compensation disclosure more closely to the accounting rules under FAS 123R, the following should be noted:
    - Compensation costs relating to stock and option awards granted in previous fiscal years may be reported in the tables in the last completed and subsequent fiscal years.
    - The compensation costs may include amounts earned by an executive that have been capitalized on the balance sheet during the fiscal year, as well as amounts recorded as compensation expense in the income statement for the fiscal year.
    - Stock-based awards that are classified as "liability awards" under FAS 123R, such as cash settled stock appreciation rights (SARs) or awards with other features that do not

[3] The alternative disclosure principles underlying the amendments were considered by the SEC, but not applied, both at time the new disclosure rules were proposed in January 2006 and when the previously final rules were adopted in August 2006.

result in an individual bearing the risks and rewards normally associated with share ownership for a specified period of time, will have compensation costs based upon re-measurements of market prices or other assumptions at each financial statement reporting date. Accordingly, the associated reported compensation costs for a fiscal year may be negative.

- Compensation costs for awards containing a performance-based vesting condition will be disclosed in the summary compensation table or director compensation table only if it is probable that the performance condition will be achieved.[4]

- If an executive or director fails to perform the requisite service to vest in an award and forfeits the award, the amount of compensation previously disclosed in the summary compensation table or director compensation table will be deducted for the fiscal year in which the award was forfeited.[5] As the amendments are currently written, this could result in a negative number in the summary compensation table or director compensation table and may result in a departing executive not being considered a "named executive officer" based upon his or her total compensation.

- Compensation costs could be reported for a fiscal year prior to the fiscal year in which the award is actually granted if an individual is rendering services in exchange for an award before the terms of the award have been finalized.

- If a retirement eligible individual would be entitled to retain an award at retirement, then the full grant date fair value is recognized in the fiscal year of grant, regardless of any stated vesting terms.

• In addition, repriced or materially modified options, SARs and similar instruments will be treated in the grants of plan-based awards table (and in footnotes to the director compensation table) in a manner similar to that of new grants, with disclosure of the incremental fair value computed as of the repricing or modification date in accordance with

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[4] If the achievement of the performance condition becomes probable in a subsequent fiscal year, the amount of compensation cost based upon the service rendered to date would be disclosed in the summary compensation table or director compensation table. If, on the other hand, the achievement of a performance condition that was previously considered probable is subsequently no longer considered probable, the amounts of compensation cost previously disclosed in the summary compensation table or director compensation table would be reversed in the fiscal year in which such a determination is made.

[5] Companies must also include a footnote describing all forfeitures during the fiscal year.

FAS 123R, and are no longer required to be referenced in a footnote in to the summary compensation table for named executive officers.[6]

- Companies will no longer be able to report under the column of the alternative form of compensation elected any salary or bonus forgone at the election of a named executive officer (or fees foregone at the election of a director) in favor of receiving a non-cash form of compensation, but must report such earnings as salary or bonus (or director's fees)[7] with appropriate footnote disclosure (which, in the case of named executive officers, must refer to the grants of plan-based awards table where the alternative form of compensation elected by the executive is reported).

This alert is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as memoranda regarding recent corporate reporting and governance developments, can be obtained from our website, www.simpsonthacher.com.

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6 This disclosure would not be required in the case of any repricing or other modification that occurs through a pre-existing formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an antidilution provision in a plan or award, or a recapitalization or similar transaction equally affecting all holders of the shares underlying the options or SARs.

7 The column heading of "Fees earned or paid in cash" in the director compensation table has not been changed.