

LEGAL ALERT

Harris Beach PLLC

May 2006

Preparing for the SEC's Proposed Changes to Executive Compensation and Related Person Disclosure and Other Proposed Rule Changes

The Securities and Exchange Commission ("SEC") has proposed significant changes to its rules governing executive compensation and related party disclosure.¹ Comments to the SEC's proposed rules were due April 10, 2006. To date, the SEC has received close to 20,000 letters commenting on its proposed rules; and, although the SEC's proposed rules will be modified in response to these comments, the adoption of final rules significantly altering executive compensation and related person disclosure to be effective in time for the 2007 proxy season would appear absolute². Companies should be evaluating their board of directors and committee policies and objectives with respect to executive and director compensation and related party transactions to determine what, if anything, they should be doing in anticipation of the 2007 proxy season.

I. Summary of some of the more significant compensation and related party disclosure proposed changes.

- **New "Compensation Discussion and Analysis."** The SEC's proposals will require a narrative discussion of the objectives and implementation of a company's executive compensation policies in a new "Compensation Discussion and Analysis" section. The "Compensation Discussion and Analysis" section will replace the current Compensation Committee Report and stock Performance Graph.
- **Expanded and reorganized Summary Compensation Table.** The Summary Compensation Table will be expanded to require disclosure of the dollar value of "total compensation" (as opposed to just salary and bonus) for a company's named executive officers, including the grant date fair value of all stock-based and option-based awards, earnings on outstanding equity-awards, earnings on deferred compensation and the annual increase in the actuarial value of any qualified and non-qualified defined benefit pension plan accruals.
- **Revisions and guidance regarding perquisites disclosure and other personal benefits.** The proposals include interpretative guidance for determining perquisite disclosure, which is applicable currently and under the proposed rules. In addition, the perquisite threshold will be lowered to \$10,000 for purposes of identifying and reporting perquisites. The current rules permit omission of perquisites and other personal benefits if the aggregate amount

¹ SEC Release No. 33-8655 – Executive Compensation and Related Party Disclosure.

² Under the proposed rules, following publication of the adopting SEC release, the new rules and amendments would apply to: proxy statements that are filed 90 days or more after publication; annual reports on Form 10-K (and Form 10-KSB) for fiscal years ending 60 days or more after publication; current reports on Form 8-K for triggering events that occur 60 days or more after publication; and registration statements that become effective 120 days or more after publication. SEC Release No. 33-8655, Part VII.

of such compensation is the lesser of either \$50,000 or 10% of the total annual salary and bonus reported by the named executive officer.

- **More focused and expanded disclosure of incentive awards and equity holdings.** New tables will require new disclosure regarding performance-based and non-performance based incentive awards and the value of and amounts realized on vesting or exercise of previously awarded and outstanding equity awards.
- **New and expanded retirement and change-in-control disclosure.** New tables and narrative disclosure will be required regarding retirement plans and deferred compensation plans and estimated amounts payable upon termination of employment and a change-in-control.
- **New definition of “named executive officers.”** The chief executive officer and chief financial officer will be “named executive officers” regardless of compensation. The three other most highly compensated executives will be “named executive officers” determined based on total compensation, as opposed to only salary and bonus.
- **New disclosure of non-executive highly compensated employees.** New disclosure is proposed regarding up to three non-executive employees whose total compensation for the last completed fiscal year exceeded that of any of the named executive officers.
- **Compensation committee must either approve non-named executive officer’s compensation or disclose.** Disclosure of the compensation for executive officers who are not “named executive officers” will be required as a “related person transaction” under Item 404 of Regulation S-K unless such compensation has been approved by the company’s compensation committee (or group of independent directors performing a similar function).
- **Revised disclosure of director compensation.** A new table and improved narrative disclosure for director compensation will be required, replacing current director compensation disclosure requirements.
- **Revised related person transaction rules.** The SEC will eliminate the “bright-line” tests for determining materiality of a related party transaction (which will be called a “related person” transaction), and will focus on the materiality of the transaction to investors. The \$60,000 transaction threshold will be increased to \$120,000, and a company will have to disclose its policies for reviewing, approving and ratifying related person transactions.
- **Additional disclosure regarding pledged securities.** Disclosure of stock pledged as collateral by named executive officers and directors, and directors’ qualifying shares will be required.
- **Expanded disclosure of compensation committee process and procedures.** The compensation committee will need to disclose the committee’s process and procedures in making recommendations regarding compensation.
- **Director independence disclosure.** The proposals will require a company to disclose related person transactions and relationships considered by the board of directors in determining the independence of a director even if such transactions are not otherwise reportable.

II. Compensation Discussion and Analysis

The SEC proposes the inclusion of a new “Compensation Discussion and Analysis” (“CD&A”) section that will include an explanation of the material elements of a company’s executive compensation policies and decisions regarding executive compensation. A company will be required to describe:

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

The CD&A is intended to be the “overview” of the more detailed compensation disclosure provided elsewhere in the proxy statement or periodic report, namely the tables and narrative discussions following and explaining the tables. The scope of the CD&A is intended to be comprehensive and company specific; boilerplate disclosure will not be responsive, and discussions of in-service compensation arrangements as well as post-termination arrangements will be required. The objective of the CD&A is to provide investors with a clear understanding of a company’s compensation policies and decisions for, and as between, its individual named executive officers. To the extent there are material differences in compensation policies and decisions, these differences must be identified and discussed. The SEC has provided examples of the compensation related issues that a company might discuss in its CD&A, including:

- the company’s policies for allocating between long-term and currently paid out compensation;
- the company’s policies for allocating between cash and non-cash compensation, and for allocating among different forms of non-cash compensation;
- the company’s basis for allocating long-term compensation among each different form of award (such as the relationship of the award to the achievement of the company’s long-term goals, management’s exposure to downside equity performance risk, and the correlation between the cost to the company and the expected benefits);
- how the company determines when equity-based awards should be granted;
- what specific items of the company’s performance are taken into account in setting compensation policies and what factors are considered in deciding whether company-performance based compensation should be paid;

- how specific forms of compensation are structured to reflect the company's performance and the executive's individual performance and/or individual contributions, including a description of the elements of individual performance and/or contribution taken into account and whether discretion can be exercised (either to award compensation absent attainment of the relevant performance goals or to reduce or increase the size of an award);
- the factors considered in deciding whether to materially increase or decrease compensation;
- 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 the 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 the company's executive officers in determining executive compensation.

Under the proposed rules, the current Compensation Committee Report and the stock Performance Graph will be eliminated. The CD&A, unlike the Compensation Committee Report and the stock Performance Graph, however, will be considered "*filed*" (as opposed to "*furnished*") for purposes of liabilities under section 18 of the Securities Exchange Act of 1934 and, to the extent the CD&A is included or incorporated by reference into a periodic report, the disclosure will be covered by the certifications of the company's principal executive and financial officers.

III. The Compensation Tables

Tabular compensation disclosure will continue under the SEC's proposed rules. In an effort to help investors understand how items of compensation relate to each other, the compensation tables and their accompanying narrative disclosures will be reorganized into three broad categories:

- compensation for the last three most recently completed fiscal years as reflected in a revised Summary Compensation Table that presents compensation paid currently or deferred and compensation consisting of current earnings or awards that are part of a plan;
- equity-based compensation holdings; and

- retirement and other post-employment compensation, including retirement and deferred compensation plans, other retirement benefits and other post-employment benefits, such as those payable in the event of a change-in-control.

A. Summary Compensation Table.³

The Summary Compensation Table will remain the principal disclosure vehicle regarding executive compensation. The Summary Compensation Table will be revised to include a “total compensation” column ((c)), which will show the aggregate dollar value of all compensation earned by each named executive officer, whether paid currently or deferred, for the covered fiscal year. In addition, two supplementary tables disclosing additional, back-up information about grants of performance-based awards and grants of all other equity awards will be included with the Summary Compensation Table to provide investors with a clearer picture of total compensation and the relationship between the various forms of compensation earned.

Currently, companies are required to report compensation deferred at the election of a named executive officer in the salary or bonus columns, as applicable. The proposed rules will modify this disclosure, to require disclosure of all deferred compensation by footnote to the appropriate column in the Summary Compensation Table. The amount deferred will also be required to be disclosed as a contribution in the new proposed “Nonqualified Defined Contribution and Other Deferred Compensation Plans” table discussed below.

The “stock awards” column ((f)) of the Summary Compensation Table will disclose the grant date fair value of stock-related awards, which will be determined pursuant to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123R); awards that derive their value from the company’s equity securities or permit settlement by issuance of the company’s equity securities, such as restricted stock, restricted stock units, phantom stock, phantom stock units, common stock equivalent units or other similar instruments that do not have option-like features will be disclosed in this column. The “option awards” column ((g)) will disclose the grant date fair value (also determined pursuant to FAS 123R) of awards of options, stock appreciation rights and similar stock-based compensation instruments that have option-like features. The SEC proposal will also require companies to include a footnote to the Summary Compensation Table disclosing all relevant assumptions made in its FAS 123R valuations, by reference to a discussion of the assumptions in the company’s financial statements, footnotes to financial statements or MD&A. Because the Summary Compensation Table will disclose the grant date fair value of equity-based awards, the columns in the current “Option/SAR Grants in Last Fiscal Year” table requiring disclosure of the potential realizable value of each grant of options at an assumed five percent and ten percent annual rate of return or, alternatively, the present value of each grant will be eliminated.

In an effort to consolidate related elements of compensation, companies will identify and quantify all earnings on outstanding equity-based awards, whether or not such earnings were paid currently, deferred or payable by their terms at a later date, by footnote to the applicable stock awards and option awards columns (see discussion below on Outstanding Equity Awards and Exercises).

Grants of equity-based awards will be disclosed in either the new supplemental “Grants of All Other Equity Awards” table, if the awards are not performance based (*i.e.*, *no performance*

³ See form of Summary Compensation Table, as proposed in Annex A attached.

conditions are required to be satisfied as a condition to payment), or the new “Grants of Performance-Based” for performance based awards. Both tables are discussed below.

The “non-stock incentive plan compensation” column ((h)) will disclose the dollar value of all amounts earned during the fiscal year pursuant to incentive plans, where the relevant performance measures are not based on the price of the company’s equity securities or the award cannot be settled in company equity securities (those awards – awards that involve share-based payment arrangements - will be disclosed in either column (f) – stock awards – or column (g) – option awards). The grant of non-stock incentive based awards will be disclosed in the new supplemental “Grants of Performance-Based Awards” table in the year of grant, which will likely have occurred in some year prior to the required disclosure in the non-stock incentive plan compensation column in the Summary Compensation Table. For example, awards based on a return of assets, return on equity, performance of a division or other such measures will be reported in the Summary Compensation Table – column (h) - when earned, not when granted.

The “all other compensation” column ((i)) will disclose the dollar value of all compensation not otherwise disclosed in columns (d) through (h), and each item of compensation included in the “all other compensation” column that exceeds \$10,000 must be separately identified and quantified in a footnote; although each item of compensation less than \$10,000 will still be included in the “all other compensation” column (other than, as discussed below, aggregate perquisites and other personal benefits less than \$10,000), these items will not have to be separately identified in a footnote. In the case of perquisites or personal benefits, if the aggregate value of all perquisites and personal benefits exceeds \$10,000, then each perquisite or other personal benefit must be separately identified and, if a perquisite or other personal benefit is valued at the greater of \$25,000 or 10% of total perquisites and other personal benefits, its value must be separately disclosed. The “all other compensation” column must include, but is not limited to:

- all earnings on deferred compensation that is not tax-qualified, including earnings on non-qualified defined contribution plans;
- the aggregate of the increase in the actuarial value to the named executive officer of defined benefit and actuarial pension plans (including supplemental plans) accrued during the covered fiscal year;
- perquisites and other personal benefits, if the aggregate amount of such compensation exceeds \$10,000⁴;

⁴ **“Perquisites or Other Personal Benefits”** - While the SEC does not propose to include a definition of “perquisites or other personal benefits”, it did provide the following interpretive guidance for purposes of determining whether an item should be considered a “perquisite or personal benefit”: among the factors to be considered in determining whether an item is a perquisite or other personal benefit are the following: • an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive’s duties; • otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees. The concept of a benefit that is “integrally and directly related” to job performance is a narrow one; it may extend, among other things, to office space at a company business location, a reserved parking space that is closer to business facilities but not otherwise preferential or additional clerical or secretarial services devoted to company matters; it does not extend to items that facilitate job performance, such as use of company-provided aircraft, yachts or other watercraft, commuter transportation services, additional clerical or secretarial services devoted to personal matters, or investment management services. Examples

- amounts paid or accrued to a named executive officer pursuant to a plan or arrangement in connection with any termination of employment, including through retirement, resignation, severance or constructive termination (including through a change in responsibilities) or a change in control; the purpose of this item is to disclose current year compensation and not aggregate amounts potentially payable in the future under post-employment benefits;
- annual company contributions or other allocations to vested and unvested defined contribution plans;
- the dollar value of any insurance premiums paid by or on behalf of the company with respect to life insurance for the benefit of a named executive officer;
- “gross-ups” or other amounts reimbursed during the fiscal year for the payment of taxes; and
- for any security of the company or its subsidiaries purchased from the company or its subsidiaries (through deferral of fees or otherwise) at a discount from the market price of such security at the date of purchase, unless that discount is available generally either to all security holders or to all salaried employees of the company, the compensation cost computed in accordance with FAS 123R.

B. Supplemental Annual Compensation Tables

Two new supplemental disclosure tables will be added to help explain the information disclosed in the Summary Compensation Table: the “Grants of Performance-Based Awards” table and the “Grants of All Other Equity Awards” table⁵.

The “Grants of Performance-Based Awards” table will provide additional information about performance-based awards. For purposes of this table, awards will be considered performance-based if they are subject to either a performance condition or a market condition, as those terms are defined in FAS 123R. Disclosure in this table of grants of incentive plan awards will complement the disclosure in the Summary Compensation Table of the grant date fair value of stock and option awards and annual earnings on non-stock based incentive

of items requiring disclosure as perquisites or personal benefits include: 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 and other living expenses (including but not limited to relocation assistance and payments for the executive or director to stay at his or her personal residence), security provided at a personal residence or during personal travel, commuting expenses (whether or not for the company’s convenience or benefit), and discounts on the company’s products or services not generally available to employees on a non-discriminatory basis. In addition, business purpose or convenience does not affect the characterization of an item as a perquisite or personal benefit where it is not integrally and directly related to the performance by the executive of his or her job. Therefore, for example, a company’s decision to provide an item of personal benefit for security purposes does not affect its characterization as a perquisite or personal benefit. A company policy that for security purposes an executive (or an executive and his or her family) must use company aircraft or other company means of travel for personal travel, or must use company or company-provided property for vacations, does not affect the conclusion that the item provided is a perquisite or personal benefit.

⁵ See form of “Grants of Performance-Based Awards” table and form of “Grants of All Other Equity Awards” table, each as proposed in Annex A attached.

compensation. Among other items, the “Grants of Performance-Based Awards” table will provide investors with the dollar value of the estimated future payout or the number of shares to be awarded upon satisfaction of the performance conditions of each performance based award.

The “Grants of All Other Equity Awards” table will provide additional information about non-performance, equity-based compensation awards granted in the last fiscal year, such as stock, options or similar instruments where the payout or future value is tied to the company’s stock price, and not to other performance criteria. This table will replace the current Options/SARs Grants table.

C. Narrative Disclosure to Summary Compensation Table and Supplemental Tables

The SEC proposals will require a narrative to the Summary Compensation Table and the supplemental disclosure tables to provide additional, qualitative information necessary to an understanding of the data provided in the tables, including material terms of employment agreements, material terms and conditions of performance awards, information regarding defined benefit and deferred compensation plans (e.g., *material assumptions underlying the determination of the amount of increase in actuarial value of defined benefit or actuarial plans*) and material waivers or modifications of performance targets, goals or conditions to payout.

D. Outstanding Equity Awards and Exercises

Two new tables are proposed to provide investors with a better understanding of equity compensation that has previously been awarded and remains outstanding; one table – Outstanding Equity Awards at Fiscal Year-End⁶ - will report all previously awarded equity grants to named executive officers that are outstanding at the end of the last completed fiscal year, but have not yet been realized, and one table – Option Exercises and Stock Vested⁷ - will show the exercise or vesting of equity awards during the last completed fiscal year, including the total dollar value of gain realized upon exercise of options and stock appreciation rights and vesting of stock awards, and the grant date fair value previously reported in the Summary Compensation Table.

E. Post-Employment Compensation

I. **Defined Benefit Plans.** In an effort to provide investors with a better understanding of the value of retirement benefits payable at normal retirement age and, if applicable, early retirement, the SEC proposed rules will require a new “Retirement Plan Potential Annual Payments and Benefits” table⁸ disclosing estimated annual retirement payments under defined benefit plans for each named executive officer at, following or in connection with retirement. Separate line item disclosure will be required for each plan that provides for specified retirement payments and benefits, or payments and benefits that will be provided primarily following retirement, including tax-qualified defined benefit plans, supplemental employee retirement plans and cash balance plans, but excluding tax-qualified defined contribution plans and non-qualified defined contribution plans. The “Retirement Plan Potential

⁶ See form of “Outstanding Equity Awards at Fiscal Year-End” table, as proposed in [Annex A](#) attached.

⁷ See form of proposed “Option Exercises and Stock Vested” table in [Annex A](#) attached.

⁸ See form of proposed “Retirement Plan Potential Annual Payments and Benefits” table in [Annex A](#) attached.

Annual Payments and Benefits” table will be followed by a narrative discussion of plan(s) features or other factors necessary to understand the plan(s), including:

- the material terms and conditions of payments and benefits available under the plan, including the plan’s normal retirement payout and benefit formula and eligibility standards, and early retirement arrangements;
- if the executive or company may elect a lump sum distribution, the amount of such distribution that would be available on election as of the end of the company’s last fiscal year, disclosing the valuation method and material assumptions applied in quantifying such amount;
- the specific elements of compensation, such as salary and various forms of bonus, included in applying the payment and benefit formula, identifying each element of compensation;
- the company’s reasons for each plan in which executive’s participate; and
- company policies with regard to such matters as granting extra years of credited service.

2. Non-Qualified Defined Contribution and Other Deferred Compensation.

In order to provide more complete disclosure of potential post-employment compensation, the proposals will require a new “Non-Qualified Defined Contribution and Other Deferred Compensation Plans” table⁹ that will disclose contributions, earnings and balances under non-qualified defined contribution and other deferred compensation plans. The table will be followed by a narrative description of material factors necessary to understand the information disclosed in the table; such factors might include:

- the type(s) of compensation permitted to be deferred, and any limitations (by percentage of compensation or otherwise) on the extent to which deferral is permitted;
- the measures of calculating interest or other plan earnings (including whether such measure(s) are selected by the named executive officer or the company and the frequency and manner in which such selections may be changed), quantifying interest rates and other earnings measures applicable during the company’s last fiscal year; and
- material terms with respect to payouts, withdrawals and other distributions.

3. Change-in-Control and Termination Compensation Disclosure. Under the SEC’s proposed rules, companies will need to provide more detailed disclosure of termination and change-in-control provisions (both written and unwritten). As proposed companies will be required to disclose the following information:

- the specific circumstances that would trigger payment(s) under the termination or change-in-control arrangements or the provision of other benefits, including perquisites and other personal benefits;

⁹ See form of proposed “NonQualified Defined Contribution and Other Deferred Compensation Plans” table in Annex A attached.

- the estimated annual payments and benefits that would be provided in each termination circumstance, and whether such payments and/or benefits would or could be lump-sum or annual, disclosing the duration and by whom such payments and benefits would be provided;
- the specific factors used to determine the appropriate payment and benefit levels under the various circumstances that would trigger payments or provision of benefits;
- any material conditions or obligations applicable or necessary for the receipt of payments or benefits, including non-compete, non-solicitation, non-disparagement or confidentiality covenants; and
- any other material features necessary for an understanding of the company's termination and change-in-control provisions.

Quantitative information responsive to this item will be required even if a company is uncertain as to the actual amounts payable; in the event uncertainties exist as to the provision of payments or benefits or the amounts involved, a company will be required to make reasonable estimates and disclose material assumptions underlying the estimates in its disclosure.

IV. Named Executive Officers and New Narrative Disclosure for Non-Executive Highly Compensated Employees

Under the SEC's proposed rules, a company's principal executive officer and principal financial officer and the three most highly compensated executive officers (other than the principal executive officer and principal financial officer) will be the "named executive officers". The dollar threshold for determining the "most highly compensated executive officers" under the proposed rules is \$100,000 of total compensation, as opposed to \$100,000 based only on total annual salary and bonus for the last completed fiscal year. The proposals will eliminate the "not recurring and unlikely to continue"¹⁰ exclusion for purposes of determining an executive officer's total compensation.

In addition, for purposes of providing shareholders with information about the use of corporate assets to compensate extremely highly paid non-executive employees (*i.e.*, *non-policy making employees*), the proposals require disclosure for up to three employees who were not executive officers during the last completed fiscal year and whose total compensation for the last completed fiscal year was greater than that of any of the company's named executive officers. The item will require disclosure of the amount of each of such employee's total compensation for the most recently completed fiscal year and a description of his or her job position. The individuals will not need to be named.

V. Compensation of Directors

Under the proposed rules, director compensation will be disclosed in a new "Director Compensation"¹¹ table which will show director compensation for the company's last completed

¹⁰ Under the current rules, companies are permitted to exclude an executive officer (other than the chief executive officer) from the definition of "named executive officer" due to an unusually large amount of cash compensation that is not part of a recurring arrangement and is unlikely to continue.

¹¹ See form of proposed "Director Compensation" table in Annex A attached.

fiscal year. Among other items of compensation to be disclosed in the “Director Compensation” table, the “all other compensation” column will show each item of compensation for the last completed fiscal year not properly disclosed in columns (c) – (f) of the proposed “Director Compensation” table, which must be identified and quantified in a footnote if the amount of the compensation item exceeds \$10,000 (or in the case of any perquisites or personal benefits, must be itemized unless the aggregate value of perquisites and personal benefits is less than \$10,000, and must be quantified if the perquisite or personal benefit is valued at the greater of \$25,000 or 10% of total perquisites and personal benefits of the director). Such compensation must include, but is not limited to:

- all perquisites and other personal benefits if the total is \$10,000 or greater;
- all earnings on non-tax qualified deferred compensation;
- all tax reimbursements;
- annual company contributions or other allocations to vested and unvested defined contribution plans;
- the compensation cost computed in accordance with FAS 123R for any security of the company or its subsidiaries purchased from the company or its subsidiaries (through deferral of fees or otherwise) at a discount from the market price of such security at the date of purchase, unless the discount is generally available to all security holders or to all salaried employees of the company;
- the amount paid or accrued to any director pursuant to a plan or arrangement in connection with the resignation, retirement or any other termination of such director; or a change-in-control of the company;
- aggregate annual increase in actuarial value to the director of all defined benefit and actuarial pension plans (including supplemental plans) accrued;
- all consulting fees;
- the annual cost of future donations to be made by the company in a director’s name, with accompanying footnote disclosure of the total dollar amount and other material terms of such legacy program(s); and
- the dollar value of any insurance premiums paid by, or on behalf of, the company for life insurance for the director’s benefit.

In addition to the disclosure specified in the columns of the “Director Compensation” table, the SEC’s proposed rules will require companies to disclose, for each director, by footnote to the appropriate column, the outstanding equity awards at fiscal year end as would be required if the “Outstanding Equity Awards at Fiscal Year-End” table for named executive officers were required for directors.

VI. Other Compensation and Related Transactions Proposed Rule Changes

A. **Elimination of Relocation Plans.** The SEC's proposes to eliminate "relocation plans" from permitted compensation omissions under Item 402 disclosure.¹² Accordingly, companies will be required to disclose relocation plan benefits even where the plan applies on the same terms to all salaried employees.

B. **Beneficial Ownership Disclosure – Pledged Stock.** The proposed rules will require new footnote disclosure to the beneficial ownership table of the number of shares pledged as collateral (security) by each named executive officer, director and director nominee, and for all directors and officers as a group. In addition, companies will be required to disclose directors' qualifying shares.

C. **Certain Relationships and Related Transactions Disclosures.** In addition to proposed changes to executive compensation, the SEC has also proposed significant changes to the disclosure of relationships and transactions between "related persons" and the company.

I. **Broad Principle-Based Disclosure.** The proposals establish a "general statement of the principle of disclosure" followed by specific disclosure requirements and instructions." Under broad principle-based disclosure, companies will be required to report transactions in the past fiscal year or any currently proposed transactions in which: • the company was or is to be a "participant" (rather than being "a party"); • the amount involved exceeds \$120,000 (increased from the current \$60,000 threshold); and • any "related person" had, or will have, a direct or indirect material interest.

With respect to each such reportable related person transaction, a company will be required to disclose: • the name of the related person and the basis on which the person is a related person; • the related person's interest in the transaction with the company, including the related person's position(s) or relationship(s) with, or ownership in, a firm, corporation, or other entity that is a party to, or has an interest in, the transaction; • the approximate dollar value of the amount involved in the transaction and of the amount of the related person's interest in the transaction¹³; and • any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction.

The following related person transactions will be exempt from disclosure:

- disclosure of compensation to an executive officer if the compensation is reported pursuant to Item 402 of Regulation S-K;

¹² A company is currently permitted to omit from Item 402 disclosure "information regarding group life, health, hospitalization, medical reimbursement or relocation plans that do not discriminate in scope, terms or operation, in favor of executive officers or directors of the company and that are available generally to all salaried employees." (Item 402(a)(7)(ii)).

¹³ The "dollar value" will be computed without regard to the amount of profit or loss involved in the transaction and, in the case of indebtedness, disclosure of the • largest aggregate amount of principal outstanding during the period for which disclosure is provided, • aggregate amount of principal outstanding as of the latest practicable date, • amount of principal and interest paid during the periods for which disclosure is provided, and • rate or amount of interest payable on the indebtedness will be required.

- compensation for services paid to an executive officer, if such compensation was approved by the compensation committee of the board of directors (or group of independent directors performing a similar function) and the executive officer is not an immediate family member of a related person (notably, this proposed change means, that if an executive officer's compensation is not approved by a company's compensation committee (or group of independent directors performing a similar function), disclosure of such compensation will be required);
- disclosure of compensation to a director (or director nominee) if the compensation is reported pursuant to Item 402(l)[as proposed];
- disclosure of amounts due from a related person for purchases of goods and services subject to usual trade terms, for ordinary business travel and expense payments and for other transactions in the ordinary course of business; and
- indebtedness, if the lender is a bank, savings and loan association, or broker-dealer extending credit under Federal Reserve Regulation T and the loans are not disclosed as nonaccrual, past due, restructured or potential problems, and the company's disclosure includes statement, if correct, that the loans were made in the ordinary course of business, they were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the bank and they did not involve more than the normal risk of collectibility or present other unfavorable features.

2. **New "Related Person" Definition.** The SEC proposes to define the term "related person" to mean (i) any person who was, at any time during the period for which disclosure is provided (notwithstanding that such person was a related person during only part of the last fiscal year and/or is not a related person at the end of the year), the company's executive officers, directors, director nominees, and any "immediate family member" of the foregoing persons, which means children, stepchildren, parents, stepparents, spouses, siblings, mother-in-law/father-in-laws, daughter-in-law/son-in-laws, sister-in-law/brother-in-laws and persons (other than a tenant or employee) sharing the household of a related person; and (ii) any person who owned, beneficially or of record, more than 5% of the any class of the company's voting securities or any immediate family member of any such person, when a disclosable transaction in which such security holder or immediate family member had a direct or indirect material interest occurred or existed.

3. **New Definition of "Transaction".** The term "transaction" will be amended to have a broader scope of coverage to include, among other things, any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships, including indebtedness and guarantees of indebtedness.

4. **Materiality.** Whether a transaction is material for purposes of disclosure will continue to be determined on the basis of the significance of the information to investors in light of all the circumstances and the significance of the interest to the person having the interest. However, the SEC proposes to eliminate current instructions that establish presumptions as to materiality¹⁴

¹⁴ Instruction 7 to Item 404(a) and Instruction 9 to Item 404(a) would be eliminated.

5. **Elimination of Distinction between Indebtedness of Management and Other Transactions.** The SEC's proposed rules will integrate the current relationship and related transaction disclosure for indebtedness under Item 404(c) of Regulation S-K with the disclosure requirements under Item 404(a) of Regulation S-K. Under the proposed rules, indebtedness transactions with regard to all related persons, including significant shareholders and their immediate family members, will be reportable.

6. **Disclosure of Procedures for Approval of Related Person Transactions.** Under the SEC's proposed rules, a company will be required to describe the material features of its policies and procedures regarding its review, approval or ratification of reportable transactions with related persons. Companies will be required to describe the material features of these policies and procedures, which description might include, among other things: • the types of transactions that are covered by a company's policies and procedures, and the standards to be applied pursuant to such policies and procedures; • the persons or groups of persons on the board of directors or otherwise who are responsible for applying such policies and procedures; and • whether such policies and procedures are in writing. If a company's policies and procedures are not in writing, the company will be required to explain how such policies and procedures are otherwise evidenced. In addition, under the proposals, companies will be required to identify any related person transaction(s) disclosed in response to Item 404(a) that was not required to be reviewed, approved or ratified under the company's policies and procedures and explain why such transaction(s) was not required to be reviewed, approved or ratified.

7. **Corporate Governance Disclosure.** The proposals will consolidate, under a single disclosure item, corporate governance disclosures currently located in several places under the SEC's rules and the principal markets' listing standards, including disclosures related to the company's audit committee (the audit committee report, audit committee financial expert and audit committee members), nominating and compensation committees, shareholder communications, compensation committee interlocks, director and committee member independence and board of directors and committee meetings.

8. **Disclosure of Independent Directors.** The SEC proposed rules will require identification of a company's independent directors (and, in the case of a proxy statement or information statement, director nominees) using a definition for director (or committee member) independence under the company's applicable listing standards. The proposals will also require disclosure of those members of a company's compensation, nominating and audit committee who are not independent directors. If a company is not a listed issuer, the proposals will require the company to disclose the standard of independence adopted by the company and disclose whether those standards are posted on the company's web site or, include a definition of independence as an appendix to the company's proxy materials at least once every three years.

9. **Director Independence and Disclosure of Director Transactions Not Otherwise Reportable.** The proposals will require disclosure of any transactions, relationships or arrangements involving a company's director or director nominee that were considered by the company's board of directors in determining that a director (or director nominee) is independent, but were not otherwise disclosed pursuant to Item 404 of Regulation S-K. This disclosure will be required for any person who served as a director during any part of the fiscal year for which disclosure must be provided, even if the person is not serving as a director at the time of filing or if such person's term will not continue after the meeting.

10. **Revised Compensation Committee Disclosure.** The SEC proposals will include new disclosure regarding a company's compensation committee and its members, similar to the information currently required with respect to a company's audit and nominating committees. The disclosure will include:

- for a company that does not have a compensation committee (or committee performing similar functions), an explanation of the board of directors's view that a compensation committee is not appropriate and the identification of each director who participates in the consideration of director and executive officer compensation;
- whether the compensation committee has a charter and, if so, the company's web site address at which a current copy is available if it is posted, and if not posted, a copy of the charter attached to the proxy statement once every three years;
- a description of the company's processes and procedures for purposes of considering and determining executive and director compensation, which will include a description of: (i) the scope of authority of the compensation committee (or persons performing the equivalent functions); and (ii) the extent to which the compensation committee (or persons performing the equivalent functions) may delegate any authority of the compensation committee to other persons, specifying what authority may be so delegated and to whom;
- any role of executive officers in determining or recommending the amount or form of executive and director compensation; and
- any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether such consultants are engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement and identifying any executive officer within the company the consultants contacted in carrying out their assignment.

11. **Proposed conforming amendments to the definition of "non-employee director" could change which directors qualify under Section 16(b).** Section 16(b) of the Securities Exchange Act permits companies and shareholders to recover profits realized by an officer, director or 10% shareholder from a purchase or sale of a company's equity securities within a period of less than six months. Rule 16b-3 of the Securities Exchange Act exempts from the short-swing profit provisions of Section 16(b) certain transactions between a company and its officers and directors if certain conditions are met. In particular, acquisitions from and dispositions to the company are exempt if the transaction is approved by the company's board of directors or a committee of the board of directors composed solely of two or more "non-employee directors". Currently, the term "non-employee director" is defined as a director who:

- is not an officer of or otherwise currently employed by the company, its parent or subsidiary;
- does not directly or indirectly receive compensation from the company, its parent or subsidiary for consulting or other non-director services, except for an amount that does not exceed the \$60,000 disclosure threshold under Item 404(a) of Regulation S-K;

- does not possess an interest in any other transaction for which Item 404(a) disclosure would be required; and
- is not engaged in a business relationship required to be disclosed under Item 404(b) of Regulation S-K.

The proposed changes to the relationships and related transactions disclosure requirements under Item 404 of Regulation S-K will result in revisions to the definition of “non-employee director” because the definition is based by reference to Item 404. The proposed conforming changes to Rule 16b-3 will continue to permit consulting and similar arrangements subject to limits measured by reference to the proposed Item 404(a) disclosure requirements, and will delete the provision referring to business relationships subject to disclosure under Item 404(b), without otherwise revising the text of the rule. Because the disclosure threshold of Item 404(a) would be increased to \$120,000 from \$60,000, the effect in some cases may be to permit previously ineligible directors to be “non-employee directors”. In other cases, where proposed Item 404(a) may require disclosure of business relationships not subject to disclosure under current Item 404(b), some current “non-employee directors” may become ineligible.

VII. Getting Organized; What Should Companies be Doing Now?

In consideration of the SEC’s proposed rules and the focus of those proposals, companies and their board of directors and relevant committees should be considering and doing the following:

A. Compensation Policies, Processes and Procedures.

- Companies should review their current compensation policies, including the objectives and implementation of such policies generally, and specific policies relating to long-term and current compensation, cash versus non-cash compensation, and performance-based versus non-performance-based compensation. The proposed rules will require detailed and expanded disclosure of the “hows” and “whys” a company makes its compensation decisions, including the processes and procedures.
- Companies should review each element of executive compensation and determine how it fits into the company’s overall compensation objectives, and how the company’s decisions regarding a particular element of compensation affects decisions regarding other elements of compensation; *review the discussion points required in the Compensation Discussion and Analysis section proposed by the SEC.*
- Companies need to review their current procedures for reviewing, approving and ratifying related party transactions.
- Compensation committee members (or persons performing the equivalent functions) should be certain that they understand all elements of executive compensation and that they annually review total compensation potentially payable to executives under all possible scenarios, including death/disability, retirement, voluntary termination, termination with and without cause and changes of control under all contracts, agreements, plans or arrangements, written or unwritten.

B. Tally Sheets.

- When considering, determining and reviewing executive compensation, the compensation committee should start with a tally sheet that lists each element of each executive officer's compensation and add it up.

C. Performance Results v. Pay.

- Compensation committees should determine that executive compensation is justified in consideration of the company's actual results versus the company's targets versus the company's peers' performance and pay.

- Compensation committees should determine that executive compensation is justified in consideration of the executive's performance and/or his or her contribution to the company's performance.

- Compensation committees should validate the prior year's compensation and confirm compensation for current year.

- Compensation committees should confirm that the company's compensation program effectively differentiates between performance to motivate (incentives) and performance to retain key talent.

D. Review the Scope and Coverage of the SEC's Proposed Rules.

- Companies should consider the SEC's proposed changes to the form and content of executive compensation and confirm that the company can provide meaningful and supportable responses, where applicable, with respect to components of and decisions about executive compensation.

- Companies should review each item of executive and director compensation or benefit of a personal nature and its cost in light of the SEC's perquisites rules and should review all elements of compensation and verify that the company's current compensation disclosure includes them all (see *Tally Sheets and Performance Analysis above*)

If you have any questions about this or any other SEC matter, please contact Catherine A. King at 315-214-2021 (or 585-419-8619) or the Harris Beach attorney with whom you usually consult.

This Legal Alert provides a brief analysis or comments on matters related to SEC proposed rules and regulations. This alert does not purport to be a substitute for advice of counsel on specific matters.

Annex A

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Total (\$)	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Options Awards (\$)	Non-Stock Incentive Plan Compensation (\$)	All Other Compensation (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Principal Executive Officer	_____ _____ _____							
Principal Financial Officer	_____ _____ _____							
A	_____ _____ _____							
B	_____ _____ _____							
C	_____ _____ _____							

OPTION EXERCISES AND STOCK VESTED

Name of Executive Officers	Number of Shares Acquired on Exercise or Vesting (#)	Value Realized Upon Exercise or Vesting (\$)	Grant Date Fair Value Previously Reported in Summary Compensation Table (\$)
(a)	(b)	(c)	(d)
Principal Executive Officer- Options			
Stock			
Principal Financial Officer- Options			
Stock			
A- Options			
Stock			
B- Options			
Stock			
C- Options			
Stock			

RETIREMENT PLAN POTENTIAL ANNUAL PAYMENTS AND BENEFITS

Name	Plan name	Number of years credited service (#)	Normal retirement age (#)	Estimated normal retirement annual benefit (\$)	Early retirement age (#)	Estimated early retirement annual benefit (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)
Principal Executive Officer						
Principal Financial Officer						
A						
B						
C						

**NONQUALIFIED DEFINED CONTRIBUTION AND
OTHER DEFERRED
COMPENSATION PLANS**

Name	Executive contributions in last FY (\$)	Registrant contributions in last FY (\$)	Aggregate earnings in last FY (\$)	Aggregate withdrawals/distributions (\$)	Aggregate balance at last FYE (\$)
(a)	(b)	(c)	(d)	(e)	(f)
Principal Executive Officer					
Principal Financial Officer					
A					
B					
C					

DIRECTOR COMPENSATION

Name	Total (\$)	Fees earned or paid in cash (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Stock Incentive-Plan Compensation (\$)	All Other Compensation (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)
A						
B						
C						
D						
E						