

The SEC's New Executive Compensation Disclosure Rules

Part I: The New Form 8-K Disclosure Requirements

Introduction

On January 27, 2006, the Securities and Exchange Commission proposed new disclosure rules for executive and director compensation, related-party transactions and corporate governance matters. During the 60-day public comment period, the SEC received one of the largest public comment responses in SEC history. When the comment period closed on April 10, 2006, the SEC had received over 20,000 comment letters. Subsequently, on July 26, 2006, the final rules were adopted by the SEC, and they were issued publicly on August 11, 2006.

These new rules represent the first major changes in executive compensation disclosure since 1992 when the SEC adopted the currently effective executive compensation rules. The final rules alter the disclosures required in proxy and information statements, periodic reports, current reports and other filings under the Securities Exchange Act of 1934, as well as registration statements under the Exchange Act and the Securities Act of 1933. The SEC's purpose in revising the executive and director compensation disclosure requirements is to give investors a clearer and more complete picture of the compensation earned by a company's principal executive officer, principal financial officer, certain other highest paid executive officers and members of its board of directors. These amendments are also intended to increase transparency of total executive compensation to investors, expand types of compensation disclosed, enhance the narrative disclosure of compensation and to provide a clear picture of use of stock options, as well as other forms of equity, to compensate executives.

As we did in the wake of the adoption of the Sarbanes-Oxley Act in 2002, we will be releasing a series of Corporate Advisories aimed at assisting our friends and clients in digesting and implementing these new rules. We will start with the revisions to Form 8-K, since these provisions will be the first to go into effect, along with a few additional preparations that companies should be making now. We will then follow up with advisories addressing the information capture needed to prepare the many new or revised tables, as well as the expanded narrative, required under the new rules, and addressing the preparation of the new Compensation Disclosure and Analysis and other narrative features of the new rules. As with our earlier advisories, we will focus not just on what the rules provide, but also on what companies can do to prepare for and ultimately comply with the new requirements. In addition, to help companies find their way through the new 8-K requirements, we have included with this advisory a [Decision Tree](#) for new Item 5.02 of Form 8-K.

New Form 8-K Requirements

In the wake of the post-Sarbanes rule-making, including the related extensive overhaul of Form 8-K, substantial confusion developed concerning the required 8-K disclosure of executive and director compensation. As a result, the SEC has adopted revisions to Items 1.01, 1.02 and 5.02 of Form 8-K to

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DECISION TREE

Item 5.02 of Form 8-K

provide more order and clarity in this disclosure. The revised Form 8-K requirements go into effect on **November 7, 2006**.

The “Old” Rules

Under Form 8-K as in effect prior to November 7, 2006, Item 1.01 of Form 8-K requires companies to disclose entry into all material definitive agreements, and material amendments to such agreements, and Item 1.02 requires disclosure of termination of such agreements, in each case within four business days of the triggering event. Item 601(b)(10) of Regulation S-K provides the definition of “material agreement,” which **deems** “any management contract or compensatory plan, contract or arrangement” with a named executive officer or director to be material, and also includes such contracts, plans or arrangements with other executive officers “unless immaterial in amount or significance.” A plethora of 8-K filings resulted from the adoption of those 8-K requirements in 2002, as companies struggled to determine the scope of materiality with respect to compensatory agreements and arrangements.

To reduce the confusion, the SEC’s newly revised 8-K requirements identify exactly whose plans, contracts and arrangements are subject to 8-K disclosure (those of the covered officers, as discussed below) and eliminate the question altogether with respect to other executive officers. The new requirements add a materiality qualifier, however, so while all plans, contracts or arrangements with the identified officers may not be **deemed** material, the company must determine *what* constitutes a disclosable plan, contract or, in particular, arrangement, based on the company’s own interpretation of materiality.

The New Rules

The new 8-K requirements have three primary impacts:

1. They remove plans, contracts and arrangements with officers and directors from the scope of Item 1.01, and remove the termination of any such plans, contracts and arrangements from the scope of Item 1.02.
2. They expand the universe of individuals for whom disclosure of appointment to or departure from certain positions is required under Item 5.02.
3. They move disclosure of compensatory plans, contracts and arrangements to Item 5.02 and define the universe of individuals for whom these disclosures must be made.

Furthermore, the limited safe harbor regarding Section 10(b) and Rule 10b-5 liability and Form S-3 eligibility in the event that the company fails to timely file certain 8-K reports is extended to include disclosure of material plans, contracts or arrangements with respect to the principal executive officer, the principal financial officer or any other named executive under Item 5.02(e) (but the safe harbor is **NOT** extended to disclosure under the other sub-sections of Item 5.02). In addition, the revised requirements delete the requirement to include the Item 1.01 heading in a Form 8-K if the information required to be disclosed under Item 1.01 is included under another Item.

Covered Officers: The new 8-K requirements in Section 5.02 require disclosure with respect to a defined universe of individuals. These individuals, referred to in most places in the release and in this advisory as the “Covered Officers,” consist of the principal officers previously included in Item 5.02, as well as anyone else who qualifies as a “named executive officer” under the revised definition in Item 402 of Regulation S-K. Specifically, these Covered Officers are:

- the principal executive officer,
- the president,
- the principal financial officer,
- the principal accounting officer,
- the principal operating officer,
- any person performing similar functions to any of the above positions, and
- any named executive officer.

The named executive officers are defined under Item 402(a) as the principal executive officer, the principal financial officer, the next three most highly compensated executive officers, and up to two

additional officers for whom disclosure would have been provided but for the fact that the individual was not an executive officer at year end. Unlike under the old disclosure requirements, the revised Form 8-K clarifies **when** to make the determination of who qualifies as a named executive officer – look to the last SEC filing that included the compensation disclosure required under Item 402(c) of Regulation S-K (usually the annual proxy statement), and the named executive officers from that filing are the named executive officers for 8-K purposes.

Required Disclosure: Once the company has identified the individuals for whom disclosure is required, the company can determine the required disclosures. In addition to the disclosure required with respect to the election or departure of a director, which does not change under the new requirements, revised Item 5.02 requires the following:

- Disclosure of the appointment of or the retirement, resignation or termination of any of the Covered Officers, including the name of the individual, his or her position and the date of appointment, retirement, resignation or termination.
- For all new appointments of Covered Officers, a description of any material plan, contract or arrangement (whether or not written) to which the Covered Officer is a party, or in which he or she participates, that is entered into in connection with the appointment, or any material amendment of any such material plan, contract or arrangement in connection with the appointment. In addition, any grant or award to a Covered Officer, or modification of such a grant or award, under any such material plan, contract or arrangement in connection with the appointment must also be disclosed. Unlike the disclosure described below, there is **NO** exception for the disclosure of a grant or award made in connection with appointment if the plan or award agreement describing the terms of the grant or award has already been disclosed and is already on file with the SEC – disclosure of grants and awards made in connection with appointment **must** be made in the Form 8-K.
- For elections of directors **other than** by a vote of security holders at a meeting called for that purpose, a description of any material plan, contract or arrangement (whether or not written) to which the director is a party, or in which he or she participates, that is entered into in connection with the election, or any material amendment of any such material plan, contract or arrangement in connection with the election. In addition, any grant or award to a director, or modification of such a grant or award, under any such material plan, contract or arrangement in connection with the election must also be disclosed. As with the similar requirement for Covered Officers, there is no exception for this disclosure of grants or awards made in connection with elections outside of an annual or special meeting.
- A brief description of any material new compensatory plan, contract or arrangement, material amendment to such plan, contract or arrangement or any new material grant under such plan, contract or arrangement, with respect to the principal executive officer, the principal financial officer or any other named executive officer¹, **any** time the company enters into, adopts or materially amends such a plan, contract or arrangement. In this circumstance, description of a new grant is limited by “materiality” and is **NOT** required if the grant is materially consistent with the terms of the plan, contract or arrangement previously disclosed and filed, and the grant itself is disclosed the next time the company makes disclosures under Item 402 of Regulation S-K (generally, in the next proxy statement). Disclosure of a plan, contract or arrangement is **NOT** required if the plan, contract or arrangement does not discriminate in scope, terms or operation in favor of executive officers or directors and is available generally to all salaried employees. **Note:** “Director-only” plans will not trigger this 8-K disclosure requirement, since it only applies with respect to the principal executive officer, the principal financial officer or any other named executive officer.²
- If the salary or bonus for a named executive officer for the most recent fiscal year could not be calculated at the time of the last proxy statement (or other filing setting forth the S-K Item 402 disclosures) and therefore was omitted from the Summary Compensation Table, disclosure of this salary and bonus when calculable in whole or in part, along with a new calculation of the “Total Compensation” figure from the Summary Compensation Table.

Filings under Item 5.02 as revised must still be made within four business days of the triggering event. Companies making these disclosures need not provide the level of detail required under the proxy disclosure rules, but rather must provide only a brief description of the applicable plan, program or arrangement.

Practical Implications of the Revised Requirements: The new requirements have several practical implications for public companies. First, the universe of covered individuals for 8-K disclosure purposes is much clearer – directors and the officers listed above under “Covered Officers,” including the named executive officers identified in the last proxy statement (or more recent filing that includes full S-K Item 402 disclosure). For 8-K purposes, companies no longer need to worry about individuals outside of the list of Covered Officers.³

Second, while a plan, contract or arrangement with respect to a Covered Officer is not “deemed” material and therefore disclosure is subject to a materiality determination, the SEC has not further clarified what is “material,” relying on the standard definition of information that impacts an investor’s decision to buy, sell or hold the company’s securities. Consequently, a materiality determination must be made with respect to disclosure of plans, contracts and arrangements, and companies should follow many of the lessons learned since the most recent expansion of the 8-K disclosure requirements following Sarbanes-Oxley, noting the SEC’s comment in the adopting and proposing releases that it believes that “much of the disclosure regarding employment compensation matters required in real-time under the Form 8-K requirements is viewed by investors as material.” Companies should also remember that not only written arrangements, but also oral ones, must be evaluated for materiality and disclosure. The SEC has also confirmed informally that offer letters to Covered Officers, even if they do not rise to the level of an “agreement,” generally fall under the term “arrangement” and should be evaluated for 8-K disclosure purposes (as well as filing purposes).

Third, when an individual is appointed to a “Covered Officer” position, or elected as a director other than at a shareholder meeting, 8-K disclosures will generally be more extensive than in the past. Companies will need to include descriptions of any material plan, contract or arrangement entered into (or amended) in connection with the appointment (not just any employment agreement, as was required under the old form). Note that the requirement is NOT limited to compensatory plans, contracts or arrangements – **any** material plan, contract or arrangement must be disclosed, although the 8-K can reference a description of the plan, contract or arrangement in the company’s most recent Form 10-K or proxy statement, if applicable, rather than repeating the description. In addition, any grants or awards under such plan, contract or arrangement, or modifications to a grant or award previously made, must now be disclosed, **even if** the terms of the plan, contract or arrangement have been previously disclosed.

Finally, 8-K disclosure of material plans, contracts or arrangements adopted, entered into, or modified separately from the appointment of a Covered Officer will now only need to be disclosed with respect to an even more limited universe of individuals – the principal executive officer, the principal financial officer or any other named executive officer.⁴ Furthermore, material grants or awards to these individuals under these plans, contracts or arrangements do not need to be disclosed if they are consistent with terms previously disclosed.

Actions Companies Can Take Now

A company may take the following steps to ease the incorporation of the new Form 8-K disclosure requirements into its disclosure regime:

- Determine who the Covered Officers are. This is the first step to ensuring the appropriate disclosures are made in a timely fashion.
- Update disclosure controls and procedures to capture necessary information about Covered Officers. This includes educating the appropriate individuals, whether they are in Human Resources, Legal, Finance or other departments, regarding the new universe of Covered Officers and the scope of information about these individuals that must be disclosed.
- Alert and educate the compensation committee about the new requirements. Actions taken by the compensation committee will directly impact the disclosure required on Form 8-K under the new requirements, and in some cases (such as actions taken in executive session), the committee may be the first to know of an event triggering disclosure.

In addition to the preparation for the new 8-K disclosures described above, companies need to take a few other steps in preparation for the other extensive disclosure changes under the new rules. While we will discuss these changes in more detail in future advisories, a few actions companies can take now are:

- Review board and compensation committee calendars for meetings scheduled between now and the filing of the proxy statement, and consider adding meetings or extra time to scheduled meetings to address the new requirements. The new disclosures will require additional committee and board review and discussion, as well as potential additional action triggered by that review. At a bare minimum, companies should assume that they will need to schedule an information session with the compensation committee to explain the impact of the new rules and the committee's role in regard to the new disclosure requirements.
- Designate an individual, or small group of individuals, with primary responsibility for collecting, evaluating and eventually drafting the information required under the new disclosure rules. Key participants in the process will be representatives from Human Resources, Legal and Finance.

In the near term, we will also distribute two more advisories on compensation:

- Information Capture for the New Executive Compensation Disclosure Rules
- Compensation Discussion & Analysis

End Notes

¹Note that this requirement applies only to the *named executive officers*, not the *Covered Officers* (although practically these two groups will overlap).

²Note, however, that for purposes of required *exhibits* to a company's periodic reports, contracts, plans and arrangements with directors are still deemed material and must be filed.

³Because the test for 8-K disclosure will differ from the test under Item 601 of Regulation S-K for filing material agreements as exhibits to periodic reports, however, companies will still need to evaluate any management contract and any compensatory plan, contract or arrangement with any executive officer to determine whether filing is required with the next periodic report.

⁴But see notes 1 and 2 above.

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