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## **SEC Releases Interpretive Guidance On New Executive Compensation Disclosure Rules**

The staff of the Securities and Exchange Commission (SEC) on January 24, 2007, issued interpretive guidance on the new executive and director compensation proxy disclosure rules. The guidance was updated on August 8, 2007, July 3, 2008, May 29, 2009, and further updated on August 14, 2009. The guidance is in the form of questions and answers of general applicability to the disclosure rules, as well as interpretive responses regarding particular situations. The guidance replaces staff interpretations issued in previous years, and is drafted in a manner that facilitates periodic future updates. The interpretative guidance is briefly summarized below with the August 14, 2009 guidance presented in *italics*.

### **Compensation Discussion and Analysis**

- The Compensation Discussion and Analysis (CD&A) disclosure requirements related to stock option grant timing and exercise price determination are applicable to all types of equity awards (not just stock options), and may require disclosure of grant practices that occurred before or after the last completed fiscal year
- When evaluating whether performance targets may be omitted from disclosure, companies must first determine if such disclosure is material to an understanding of compensation paid for the last completed fiscal year; if not material, no disclosure is required; if material, quantitative performance targets must be disclosed unless the goals involve confidential trade secrets or commercial or financial information, the disclosure of which would result in competitive harm to the company; there is no requirement to disclose quantitative targets for inherently subjective or qualitative assessments, such as “demonstrated leadership”
- When determining whether a company’s benchmarking practices need to be discussed and analyzed, “benchmarking” is defined generally as using compensation data about other companies as a reference point to provide a framework for compensation decisions; benchmarking does not include use of broad-based third-party surveys for more general understanding purposes
- If a compensation consultant plays a material role in the company’s compensation-setting practices and decisions, then discussion and analysis of that role is required in the CD&A (in addition to the required disclosure of any compensation consultant involvement in the compensation committee governance disclosures)

## **Summary Compensation Table**

- Compensation information for fiscal years prior to becoming a named executive officer does not need to be disclosed
- If an individual is a named executive officer in year 1, but not in year 2, and again in year 3, compensation information must be disclosed in the Summary Compensation Table for all three fiscal years
- If an individual ceases to be an executive officer during the fiscal year but remains employed by the company, the employee must be included in the Summary Compensation Table if the employee would otherwise be one of the two additional individuals whose total compensation for the year (based on the employee's compensation for the full year) was higher than the total compensation of the three highest paid executive officers, other than the chief executive officer and chief financial officer, who are treated as named executive officers
- Death benefits received from a company funded life insurance policy should not be taken into account when determining whether an executive is a named executive officer, and should not be reported as compensation in the Summary Compensation Table
- If the rules do not specifically limit footnote disclosure to the last completed fiscal year, footnote disclosure for prior reported years is required only if material to an understanding of compensation for the last completed fiscal year
- Following a merger among operating companies, there is no concept of "successor" compensation; therefore, the surviving company in the merger need not report compensation paid by predecessor companies that disappeared in the merger; further, compensation paid by the predecessor companies need not be counted in determining whether an individual is a named executive officer of the surviving company; different rules may apply in situations involving an "amalgamation" or combination of companies, an operating company combination with a "shell" company, or a spin-off
- Cash bonuses based on performance criteria that are substantially uncertain and communicated to participants at the onset of the performance period should be reported in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Table, regardless of the length of the performance period or whether negative discretion is permissible, and the basis for the use of negative discretion may need to be disclosed in the CD&A
- Discretionary cash bonuses that are not based on any performance criteria should be reported in the Bonus column of the Summary Compensation Table, including amounts paid in excess of amounts earned by meeting the performance criteria in a non-equity incentive plan
- Cash retention bonuses that are conditioned on future services are not reported in the bonus column until the fiscal year in which earned
- *Bonus amounts that are recovered by the company pursuant to a recoupment or clawback policy in a year subsequent to the year in which the bonus is earned should be reported as an adjustment to the Bonus Column (d) and Total Column (j) for the year in which the bonus is earned, as opposed to the year the compensation is recovered, with appropriate footnote*

*disclosure of the amount recovered; amounts recovered do not affect the named executive officer determination for the year in which the bonus is recovered*

- For arrangements in which the named executive officer may elect to receive equity compensation in lieu of what would otherwise be paid in cash, if the amount of salary or bonus forgone is less than the value of the equity compensation received, the incremental value of the equity compensation should be reported in the Stock or Option Awards column of the Summary Compensation Table, as appropriate; similarly, if the conversion election is embedded in the terms of the equity award such that the award falls within the scope of FAS 123R, the value of the equity compensation should be reported in the Stock or Option Awards column of the Summary Compensation Table, as appropriate
- The disclosure of stock or option award valuation assumptions should relate to any award reported in the Summary Compensation Table, not just for awards granted during the last completed fiscal year
- Compensation cost for stock and option awards may be reversed only to the extent such cost was previously reported in the Summary Compensation Table; that is, compensation cost recognized prior to the effective date of the disclosure rules or becoming a named executive officer should not be reversed; however, for purposes of determining the three most highly paid named executive officers, all amounts reversed during the last completed fiscal year are taken into consideration, regardless of whether such amounts were previously reported in the Summary Compensation Table
- If an equity award is granted after the end of the last completed fiscal year for which it was earned, disclosure of the award should be made in the CD&A for the last completed fiscal year, but the award should not be reported in the Summary Compensation Table or the Grants of Plan-Based Awards table until the following fiscal year in which it was granted (with the amount reported in the Summary Compensation Table being consistent with the amount recognized for financial statement reporting purposes)
- Companies with multiple pension plans are permitted to aggregate all increases or decreases in the actuarial present value of accumulated pension benefits before applying the “no negative number” provisions applicable to the Change in Pension Value column of the Summary Compensation table
- If the \$10,000 reporting threshold for perquisites is exceeded, each perquisite must be separately identified by type even if there is no incremental company cost (no reporting is required for perquisites that are fully reimbursed by the executive)
- No disclosure is required for compensatory benefits received from non-discriminatory Section 423 employee stock purchase plans
- No disclosure is required for dividends, dividend equivalents, or other earnings on equity awards granted prior to the effective date of the new disclosure rules if the earnings would have been appropriately factored into the grant date fair value of the related award in accordance with FAS 123R
- Nonqualified deferred compensation payouts are not disclosed in the Summary Compensation Table, but rather in the Aggregate Withdrawals/Distributions column of the Nonqualified Deferred Compensation table

- Tax gross-up payments should be reported in the Summary Compensation Table for the same year as the related perquisites or other compensation is disclosed, and not in the year actually paid (if later)

### **Grants of Plan-Based Awards Table**

- If an equity incentive plan award is denominated in dollars, but payable in stock, it should be reported in columns (f) through (h) of the Grants of Plan-Based Awards Table with footnote disclosure explaining the stock payout provisions; companies are permitted to change the (#) to (\$) in the column headers if all awards in the column are structured that way
- For cash awards that are made in the same year they were earned under an annual non-equity incentive plan (and the amounts are disclosed in the Summary Compensation Table), companies are permitted to change “future” to “possible” in the header for columns (c) through (e) of the Grants of Plan-Based Awards Table
- Disclosure is required for “reload” stock options, as well as for stock and option awards of a parent or subsidiary company
- The grant date fair value reported in column (l) of the Grants of Plan-Based Awards Table for equity incentive plan awards, such as performance shares, should (1) be based on “maximum” rather than “target” performance, (2) include all tranches of an award for which performance targets are established at the start of the performance period, (3) exclude all tranches of an award for which performance targets are established in subsequent fiscal years, and (4) include any incremental value from amended or modified awards

### **Outstanding Equity Awards at Fiscal Year-End Table**

- Dividends or dividend equivalents paid on restricted stock that are credited and reinvested into additional equity awards should be reported in the Outstanding Equity Awards at Fiscal Year-End Table while unvested, and in the Option Exercises and Stock Vested Table upon vesting
- Shares acquired upon option exercise that are subject to a company repurchase obligation (at the exercise price) are reported in columns (g) and (h) of the Outstanding Equity Awards at Fiscal Year-End Table until the repurchase obligation lapses, at which time such shares are reported in columns (d) and (e) of the Option Exercises and Stock Vested Table
- Equity incentive plan awards reported in columns (d), (i), or (j) of the Outstanding Equity Awards at Fiscal Year-End Table are based on achievement of threshold performance, except that if cumulative performance to date as of the last completed fiscal year exceeds threshold, the next higher level of performance (that is, either target or maximum) should be reported
- Equity incentive plan awards that are earned as of the last completed fiscal year end but paid in restricted stock should be reported in columns (g) and (h) rather than (i) and (j) of the Outstanding Awards at Fiscal Year-End Table, based on the actual number of equity incentive plan awards earned (even if the actual number of shares earned is determined after fiscal year end)

- It is permissible to add a grant date column to the table and a related footnote detailing the vesting schedule that relates to that grant, provided that if a different vesting schedule applies to any award the table must include disclosure about that vesting schedule

### **Option Exercises and Stock Vested Table**

- The gross number of shares underlying an exercised stock appreciation right should be reported in the Option Exercises and Stock Vested Table, not just the net profit shares
- Shares acquired upon option exercise that are subject to a company repurchase obligation (at the exercise price) should not be reported as option exercises in columns (b) or (c) of the Option Exercises and Stock Vested Table, but rather in columns (d) and (e) of the Option Exercise and Stock Vested Table as vested stock when the repurchase obligation lapses

### **Pension Benefits Table**

- When a pension plan has a stated “normal” retirement age and an early retirement age at which benefits are paid without any reduction, the early retirement age should be used for determining pension benefits (and the normal age may be included as an additional column)
- The actuarial present value of accumulated pension benefits that vest upon reaching a certain age should assume that the normal retirement age (or early retirement age, if applicable) is attained, and should ignore actuarial “pre-retirement decrements”
- The present value of accumulated benefits for a cash balance pension plan is the actuarial present value of the accumulated benefits under the plan, not simply the accrued benefits

### **Nonqualified Deferred Compensation Table**

- Earnings on non-qualified deferred compensation are not “above-market” or “preferential” if calculated in the same manner and rate as earnings on externally managed investments for employees participating in a broad-based, tax-qualified plan (this position may not be available for supplemental retirement plans that do not have any relationship to a tax-qualified retirement plan of the employer)
- Earnings include dividends, stock price appreciation or depreciation, and other similar items, and should encompass any increase or decrease in the account balance during the last completed fiscal year that is not attributable to contributions, withdrawals, or distributions during the year
- Footnote disclosure of amounts reported in the Nonqualified Deferred Compensation Table that were previously reported in the Summary Compensation Table is only required if such amounts were actually previously reported in the Summary Compensation Table
- Company contributions should include all contributions earned during the last completed fiscal year, even if actually credited to the executive’s account in the following year
- Disclosure is required on a plan-by-plan basis for all nonqualified deferred compensation and defined contribution plans, *including volitional and mandatory deferrals of vested equity awards*

## **Potential Payments upon Termination or Change in Control**

- Companies are to describe and quantify the estimated payments and benefits upon each potential triggering event, except that if a triggering event has actually occurred, disclosure is only required for that specific triggering event (even if such event occurs after the end of the last completed fiscal year but before the proxy statement is filed)
- Where the vesting of outstanding stock options is accelerated, companies are to report the “spread” between the exercise (if any) and the closing market price as of fiscal year end to calculate the value of the awards (even if the acceleration is pursuant to a broad-based equity compensation program)
- For purposes of quantifying any excise tax gross up payments, companies may not substitute the first day of the following fiscal year for the last business day of the last completed fiscal year

## **Director Compensation Table**

- Director compensation disclosure is required for persons who served as director during the last completed fiscal year but no longer serve as director at year end, or are not standing for re-election the next year
- Director or executive compensation disclosure is not required for an executive officer (who is not a named executive officer) who is also a director and does not receive additional compensation for services as a director (footnote disclosure of this fact is required)
- Companies are to provide footnote disclosure for each director of the grant date fair value of each equity award granted during the last completed fiscal year computed in accordance with FAS 123R (including the incremental fair value of repriced or materially modified option awards), and the aggregate number of stock and option awards outstanding at fiscal year end
- Charitable matching gift programs must be disclosed in the All Other Compensation column of the Director Compensation Table, even where they do not discriminate in favor of officers or directors

Finally, there is additional guidance in the interpretive responses regarding particular situations that deal with spinoffs, mergers, public offerings, changes in fiscal year end, and parent/subsidiary relationships.

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General questions about this letter can be addressed to Thomas Haines in our Chicago office at 312-332-0910 or by email at [tmhaines@fwcook.com](mailto:tmhaines@fwcook.com), or to Richard Alpern in our New York office at 212-986-6330 or by email at [ralpern@fwcook.com](mailto:ralpern@fwcook.com). Copies of this letter and other related materials are available on our website at [www.fwcook.com](http://www.fwcook.com).