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SEC Issues New Interim Final Rule on Stock Compensation Disclosures: Affects Early 2007 Filings and Can Change Who Is Reported as a "Named Executive Officer"

On December 22, 2006, the SEC adopted a new rule on how to report officer and director compensatory stock and option awards in proxy statements, information statements and registration statements, and Form 10-K Annual Reports [SEC Release Nos. 33-8765; 34-55009]. When published in the Federal Register, the new rule will, in effect, retroactively be made part of the executive compensation disclosure rule changes adopted in July 2006 and will have the same effective dates as the July 2006 rule changes. For many companies, this late December rule change will affect proxy statements and annual reports due in early 2007. The SEC is soliciting comments on this interim final rule, so there could be even more changes soon.

This new rule changes how to report the annual cost of stock compensation awards in the stock compensation tables. The goal is to have the reported annual cost for individual officers and directors tie to the methodology used by the issuer in expensing the cost of compensatory stock awards in its financial statements under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payments ("FAS 123R"). Also, some information previously required to be disclosed will now be reported in a different location. And, there are additional new disclosures required.

The new rule does not directly change the definition of the "named executive officer" group, that is, the persons whose compensation is required to be reported as part of the executive compensation disclosure. This group still includes the CEO, the CFO and the three other officers having the greatest reported annual compensation. However, by changing how to value annual stock compensation costs, the three other officers identified under the new rule could easily differ from the persons identified under the rules adopted in July 2006.

New Annual Costs

As for annual compensation costs, the Summary Compensation Table and Director Compensation Table will now show a cost that mirrors the annual charge for awards under FAS 123R – an amortized annual cost of the original award, valued at the grant date and spread over the vesting period.

Under FAS 123R, certain equity-related awards do not qualify for fixed accounting measured at the award grant and instead the costs of these "liability awards" are periodically marked-to-market and expensed in the income statement. For such awards, the SEC calls for parallel treatment in the Summary Compensation Table and Director Compensation Table and welcomes these periodic re-measurements as "a more comprehensive measure of liability over time."

Under the SEC's rules, a forfeiture of previously-awarded compensation can apparently result in negative compensation expense for individuals, so that current annual compensation can apparently go down because of forfeitures of past awards. The SEC recognizes that this can affect who is treated as a NEO in a particular year, but apparently believes the new system will be more stable and overall more helpful than the old.

The new approach can result in different reporting for different types of awards that are substantively similar. For example, under FAS 123R, awards with performance vesting may not start to be recognized in the financial statements until performance seems probable of accomplishment. The SEC recognizes this, and notes that a similarly-vesting non-equity award might, under the SEC's rules, not be reported until actually earned in full.

Grant Values Relocated

Formerly, the annual cost to be shown in the Summary Compensation Table and Director Compensation Table included the aggregate grant date fair value of awards made in the current year, even if those awards vested over several years. The disclosure of aggregate value of new awards will now be reported in a new column in the Grant of Plan-Based Awards Table (on a grant-by-grant basis), which will also report incremental fair value changes in awards for repriced or materially-modified options, SARs, etc. The Director Compensation Table must now be accompanied by footnote disclosure of the same information.

Other Changes

Other changes include a need to make a cash-based compensation disclosure of elections to forgo cash compensation for options, stock or other non-cash awards, with appropriate footnote disclosure (for the Grant of Plan-Based Awards Table) showing why the related award was issued.

Also, special transition rules apply for awards that were granted before FAS 123R became effective with respect to the issuer in question.

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This summary of the SEC's rule change is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Moreover, we are not accountants and do not purport to be interpreting FAS 123R or any other accounting statements. Questions concerning the SEC's executive compensation disclosure requirements should be directed to any of the following:

Robert C. Fleder	(212) 373-3107	Michael J. Segal	(212) 373-3364
Paul R. Koppel	(212) 373-3040	Lawrence Witdorchic	(212) 373-3327

or to any member of the Paul Weiss Securities Group, including:

Mark S. Bergman	(44 20) 7367-1601	Edwin S. Maynard	(212) 373-3034
Richard S. Borisoff	(212) 373-3153	Raphael M. Russo	(212) 373-3309
Andrew J. Foley	(212) 373-3078	Lawrence G. Wee	(212) 373-3052
John C. Kennedy	(212) 373-3025	Tong Yu	(81 3) 3597-6306