

December 28, 2006

## SEC Amends Disclosure Rules for Stock-Based Compensation

On the eve of the Christmas weekend, in a surprise move, the Securities and Exchange Commission made significant changes to its recently-adopted rules regarding disclosure of stock-based compensation.<sup>1</sup> The amendments change how stock and option awards are to be reported in executive compensation disclosure tables. The changes, which were adopted as interim final rules and will be effective immediately upon publication in the Federal Register, will apply for 2007 proxy statements.<sup>2</sup>

In adopting the rules, the SEC is aligning more closely executive compensation disclosure regarding stock and option awards with the manner in which such awards are reported in financial statements under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or FAS 123(R). In the main, this is likely to lower total compensation reported for top executives.

The SEC's executive compensation disclosure rules adopted in August 2006 required stock and option awards to be reported in the Summary Compensation Table at their full grant date fair value, even though FAS 123(R) generally calls for such awards to be recognized for financial reporting purposes over the period in which the employee is required to provide service in exchange for the award.<sup>3</sup> Following adoption of the SEC's rules, a number of commenters expressed concern with this approach, including a concern that disclosure of the full grant date fair value would overstate the compensation earned relative to service rendered for the year, and a concern that immediate reporting of the full grant date fair value might not reflect the cost to the company or the benefit to the named executive officer, depending, in part, on actual amounts earned over the life of the award.

In response to these concerns, the new rules require stock awards and option awards to be reported in the Summary Compensation Table and Director Compensation Table in an amount equal to the dollar amount recognized for financial statement reporting purposes for such awards for the fiscal year in accordance with FAS 123(R). In addition, the full grant date fair value of stock awards and option awards must continue to be reported in the year of grant, but these will now be shown in a new column added to the Grants of Plan-Based Awards Table.

Some of the key changes and consequences effected by the amendments are described in greater detail below.

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<sup>1</sup> See Executive Compensation Disclosure, Rel. No. 33-8765 (Dec. 22, 2006) (the "Release"). All references to page numbers in the Release refer to the page numbers on the pdf version of the release that is available on the SEC's website at <http://sec.gov/rules/final/2006/33-8765.pdf>.

<sup>2</sup> Although the SEC has provided for a 30-day comment period, which may give rise to further changes, the rules are final and do not require further SEC action.

<sup>3</sup> For a detailed discussion of the executive compensation disclosure rules adopted in August 2006, see Covington & Burling LLP's client advisory, [New Executive Compensation Disclosure Rules](#) (Aug. 23, 2006). See also Executive Compensation and Related Person Disclosure, Rel. 33-8732A (Aug. 29, 2006).

## Summary Compensation Table

- The amount reported for Stock Awards (column (e)) and Option Awards (column (f)) will be the dollar amount of compensation cost recognized for financial statement reporting purposes for the fiscal year in accordance with FAS 123(R), except for estimates of forfeitures as described below.<sup>4</sup> This amount will include compensation cost recognized in the fiscal year with respect to awards granted both in previous fiscal years and the subject fiscal year (subject to the transition guidance described below).
- The new rules depart from FAS 123(R) in one important respect. In determining compensation cost, FAS 123(R) requires companies to estimate the portion of awards with service-based vesting conditions that will be forfeited, i.e., not vest due to the employee leaving employment or otherwise failing to meet the service condition.<sup>5</sup> When computing amounts to be shown in the Summary Compensation Table, however, companies must disregard estimates of such forfeitures. In other words, companies should assume the named executive officer will perform the requisite service to vest in the award. However, if the officer fails to perform the requisite service and forfeits the award, the compensation cost previously disclosed in the Summary Compensation Table that relates to the forfeited portion should be deducted in the period during which the award is forfeited.<sup>6</sup> In addition, any forfeitures of stock awards or option awards during the year must be described in a footnote.<sup>7</sup>
- An award classified as a “liability” award under FAS 123(R), such as a cash-settled SAR, is required by FAS 123(R) to be re-measured, or marked to market, at each financial statement reporting date until the award is settled. Consequently, the annual change in value of such awards will be reflected in the appropriate column of each year’s Summary Compensation Table.<sup>8</sup> This annual change in value could be positive or negative, but over the life of the award the amount cumulatively recognized in the Summary Compensation Table should equal the total fair value at the date of settlement.<sup>9</sup>
- Awards with performance-based vesting conditions will be reflected in the Stock Awards or Option Awards column only to the extent it is probable that the performance condition

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<sup>4</sup> Item 402(c)(v) and (vi) of Regulation S-K. Hereafter, references to any “Item” shall mean items of Regulation S-K, unless otherwise noted.

<sup>5</sup> Instruction to Item 402(c)(v) and (vi). A “service condition” is defined in Appendix E of FAS 123(R) as a “condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period.”

<sup>6</sup> Release at 13, 15. Although the Release does not state so explicitly, presumably the amount of such deduction should be limited to the amount of previously-disclosed compensation cost that relates to the portion of the award that was forfeited. Also, it is assumed that this requirement will only apply prospectively, since there was no requirement to disclose the compensation cost of stock or option awards in the Summary Compensation Table before 2006.

<sup>7</sup> Instruction to Item 402(c)(v) and (vi).

<sup>8</sup> FAS 123(R) classifies as liability awards any awards with cash-based settlement, certain repurchase features, or other features that do not result in the employee bearing the risks and rewards normally associated with stock ownership for a specified period. See Release at 12.

<sup>9</sup> Release at 15.

will be satisfied.<sup>10</sup> If the achievement of the performance condition is not probable at the time of grant but becomes probable during a subsequent period, the proportionate amount of compensation cost based on service previously rendered will be disclosed in the applicable column of the Summary Compensation Table for the period in which achievement of the performance condition becomes probable.<sup>11</sup>

- Under transition guidance set forth in the Release, companies must utilize the FAS 123(R) modified prospective transition method for purposes of complying with Item 402, whether they have adopted that method for financial statement reporting purposes or not.<sup>12</sup> Under this method, a proportionate share of the grant date fair value of equity awards outstanding when FAS 123(R) was adopted is to be recognized over those awards' remaining vesting periods.<sup>13</sup>
- Any salary or bonus that is forgone at the election of the named executive officer in favor of receiving stock or other equity-based or non-cash compensation must be reported in the Salary or Bonus column, as applicable, with footnote disclosure of the receipt of the non-cash compensation that refers to the Grants of Plan-Based Awards Table where the non-cash compensation award elected is reported.<sup>14</sup> This is a change from the rules as originally adopted in August 2006, which had permitted such compensation to be reported either in the Salary or Bonus columns, or, alternatively, in the Stock Awards or Option Awards columns.

#### Grants of Plan-Based Awards Table

- A new column has been added (column (I)) to show, on a grant-by-grant basis, the grant date fair value, computed in accordance with FAS 123(R), of each award reported in the table.<sup>15</sup> This is the same information that was required to be reported, on an aggregate basis, in the Summary Compensation Table under the rules as originally adopted.
- The new column must also show the incremental fair value of any options, SARs or other option-like instruments that were repriced or otherwise materially modified during the year, computed in accordance with FAS 123(R) as of the date of such repricing or other

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<sup>10</sup> Release at 14. The term "performance condition" is defined in Appendix E of FAS 123(R). See Release at 14, footnote 35. Whether vesting is "probable" is determined for this purpose based on the standard set forth in Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, at paragraph 3, which defines probable as "the future event or events are likely to occur." FAS 123(R) at footnote 25.

<sup>11</sup> Release at 14. Conversely, if the achievement of a performance condition was previously considered probable but subsequently becomes not probable, the amount of compensation cost previously disclosed would need to be reversed during the period in which it is determined that achievement of the performance condition is no longer probable. *Id.*

<sup>12</sup> Release at 26.

<sup>13</sup> Liability awards that were outstanding when FAS 123(R) was adopted will be recognized until those awards are settled based on the fair values of those awards at each financial statement reporting period as well as the portion of the awards that have vested. Release at 27.

<sup>14</sup> Instruction 2 to Item 402(c)(iii) and (iv).

<sup>15</sup> Item 402(d)(2)(viii).

material modification.<sup>16</sup> This information was required to be reported in the Stock Awards or Option Awards columns of the Summary Compensation Table under the rules as originally adopted.

### Director Compensation Table

- In general, the Director Compensation Table has been revised to incorporate the same changes described above with respect to the Summary Compensation Table. For example, the amount reported for Stock Awards (column (c)) and Option Awards (column (d)) will be the dollar amount of compensation cost recognized for financial statement reporting purposes for the fiscal year in accordance with FAS 123(R), except with regard to estimates of forfeitures as described above.
- Because the Grants of Plan-Based Awards Table has no analogue for directors, the new disclosures required for named executive officers in that table must be provided for directors by means of footnotes to the Director Compensation Table. Thus, the table is now required to include, in addition to footnote disclosure already required under the existing rules, (i) the grant date fair value of each equity award reported in the Stock Awards or Option Awards columns, computed in accordance with FAS 123(R), and (ii) the incremental fair value of any options, SARs or other option-like instruments that were repriced or otherwise materially modified during the year, computed in accordance with FAS 123(R) as of the date of such repricing or other material modification.<sup>17</sup>
- It also appears that, like bonus and salary in the Summary Compensation Table, any fees that are forgone at the election of the director in favor of receiving stock or other equity-based or non-cash compensation must be reported in the Fees column of the Director Compensation Table, with footnote disclosure of the receipt of the non-cash compensation that refers to the footnote where the stock or other equity-based compensation award elected is reported.<sup>18</sup>

### Some Implications of the Revised Rules

Although the definition of “named executive officer” remains unchanged, determining which officers comprise the group of named executive officers may well be affected by the change in methodology for valuing stock awards and option awards. On balance, it seems likely that amounts in the Stock Awards and Option Awards column under the revised rules will be less than the aggregate grant date fair value of such awards as would have been required under the rules as originally adopted (although this will be offset somewhat by the requirement under the new rules to include compensation cost related

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<sup>16</sup> *Id.* As under the rules adopted by the SEC in August 2006, no such disclosure is required in connection with repricings that occur through a pre-existing formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an antidilution provision in the plan or award, or a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs. Instruction 7 to Item 402(d).

<sup>17</sup> Instruction to Item 402(k)(2)(iii) and (iv).

<sup>18</sup> See Instruction to Item 402(k), which provides that the Instructions to Item 402(c)(2)(iii) and (iv) apply equally to Item 402(k).

to both 2006 awards and pre-2006 awards). This, in turn, should have the effect of lowering the total compensation figure.

The disclosure approach followed by the new rules embraces the possibility of both upward and downward changes in the annual value of compensation attributable to stock-based awards. Indeed, in linking compensation disclosure to the amount of compensation recognized for financial statement reporting purposes, the SEC acknowledged that there may be circumstances where a named executive officer's reported stock-based compensation is negative. This may occur, for example, where the change in market value of an award classified as a liability award is negative, or where it becomes unlikely that the performance condition of a previously recognized performance-based award will be achieved. In light of these factors, some companies may find it useful to provide expanded disclosure, whether by footnote or supplemental table, to break out the individual components of compensation costs comprising amounts reported in the Stock Awards and Option Awards columns.

From a practical standpoint, companies that have performed preliminary analyses to identify the likely group of named executive officers using the methodology of the original rules will now need to re-do this work using the new rules' methodology. Just as they were adjusting to the new level of exacting detail in executive compensation disclosure rules adopted in August 2006, public companies will now need to adapt further their reporting processes to take account of the additional changes.

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