CORPORATE GOVERNANCE

LAW ALERT

August 2006

New Compensation Disclosure Rules: Special Considerations for Smaller Companies

RMF
RUSKINMOSCOUFALTISCHEK P.C.
Smart Counsel. Straight Talk.

One of the leading business law firms in the metropolitan New York region.

Michael L. Faltischek is a Senior Partner at Ruskin Moscou Faltischek, P.C. He is head of the firm's Corporate Governance Practice Group. He can be reached at mfaltischek@rmfpc.com or 516-663-6550.

Michael I. Schnipper is an Associate and is a member of the firm's Corporate & Securities Department. He can be reached at mschnipper@rmfpc.com or 516-663-6674.

Ruskin Moscou Faltischek Corporate Governance Practice Group Capabilities

- Compliance Audits
- Audit Committee Responsibility
- Compensation Committee
- Governance Committee
- Officer Certification
- Litigation
- Employment Law
- Exchange Listing Requirements
- 8K Information Reporting Requirements
- Director Independence
- Director Personal Liability
- Directors and Officer Insurance
- White Collar Crime

The Securities and Exchange Commission (SEC) has adopted new rules to govern disclosure of compensation for annual reports and proxy statements filed on or after December 15, 2006. The amendments dramatically change the scope and substance of compensation disclosure. It is expected that the new disclosure rules, particularly when Section 404 internal control obligations are considered, will create meaningful additional costs for compliance. The SEC did provide some relief to smaller public companies by extending the deadline for compliance with Section 404 of the Sarbanes-Oxley Act of 2002 which relates to audit standards and internal control obligations. However, delayed implementation will not mean exemption from the disclosure obligation and attention should be given to minimize the impact once compliance is mandatory.


Michael L. Faltischek


Michael I. Schnipper

The SEC first proposed new rules to govern compensation disclosure in January 2006. The significant impact of the compensation disclosure rules was made apparent by the fact that the SEC received more than 20,000 comments on the issue, more than any other issue in its 72-year history. In response to the concerns of companies, auditors, investors and professionals, the SEC modified its original draft rules. Even so, and despite short-term deferral of the impact on smaller public companies, immediate attention must be given to assure future compliance.

The SEC has made it clear that its goal is transparency and clarity regarding material compensation disclosure to investors. At the same time, the SEC has explicitly stated that its intent is not to regulate the level or nature of compensation but rather to ensure that the quality and usefulness of information concerning all material elements of compensation is provided to investors.

Among the most controversial of the rules proposed was the so-called "Katie Couric" rule. As originally written, this rule would require companies to disclose the compensation of the three highest paid employees other than executive officers and directors. In larger companies, this raised serious concerns with respect to the extent to which data collection was required in order to determine which non-executive employees were subject to the disclosure rules. Furthermore, it meant disclosing the identity of individuals' personal information even though they might not have a meaningful impact on the overall operations of a company. In response, the SEC has modified its requirement and is considering further changes that would limit the rule to exclude those employees who have no responsibility for significant policy decisions within a company, a subsidiary or a unit or division. There is also consideration of excluding from the disclosure (and therefore the data collection burden) those companies which have a public float of less than $75 million.

One of the key ingredients of the new rules is a more comprehensive definition of what is to be considered "compensation" for purposes of disclosure. The SEC has broken this into three broad categories: direct compensation; equity interest received that can be a source of future gains (i.e., stock grants or options); and retirement plans, deferred compensation and other post-employment plans or benefits (i.e., severance agreements). In defining what is direct compensation, the SEC has included salary, bonus and perquisites. As to the latter, there is no clear definition of what constitutes a perquisite. The SEC continues to view those items, which are integrally and directly related to the performance of an employee's duties to not be perquisites. While there may well be grey areas, items which can be expected to receive scrutiny include lavish entertainment, country clubs, relocation expenses and health club facilities.

Not included in the original rules but adopted as part of the current rules is guidance with respect to stock options. As with compensation generally, it is not the goal of the SEC to dictate how, when or the extent to which options should be used as a tool for rewarding employees. However, the need to make full and complete disclosure of all aspects of stock option granting is mandated. Thus, while there has been much publicity about "back dating", there is no prohibition to continue adoption of granting guidelines that would result in employees receiving "in the money" options as of the grant date so long as all aspects of the process are disclosed in a meaningful fashion.

Finally, the rule requires a new general disclosure by management with respect to the compensation processes. The new "Compensation Discussion and analysis" requires management to give an overview of the objectives and implementation of compensation programs for those who are subject to the compensation disclosure obligations. The compensation discussion and analysis must be filed with the SEC and certified by the Chief Executive Officer and Chief Financial Officer. Among the continuing issues of concern are how management can make proper certifications when discussing the actions of a Compensation Committee, which theoretically operates independently from management and whose deliberations may not be shared with management.

All companies must become familiar with the requirements of Section 404 of Sarbanes-Oxley when developing and applying internal control policies to assure compliance with the new compensation disclosure rules. Section 404 requires filers to include a discussion of internal control in their annual report, including a statement of the responsibility of management for establishing and maintaining an adequate internal control structure and the company's procedures for financial reporting. Section 404 also requires filers to provide an auditor's attestation report on internal control over financial reporting in their annual reports.

Recognizing the burdens already created by Section 404 and the new compensation disclosure rules, the SEC has extended the dates for compliance with Section 404 for smaller public companies. In a release dated August 9, 2006, the SEC extended the deadline for full compliance with Section 404 to the annual report for fiscal years ending on or after December 15, 2008. However, the deadline for providing a management report on internal control over financial reporting was only extended to fiscal years ending on or after December 15, 2007. As to the new executive compensation disclosure requirements discussed above, the deadline for compliance is fiscal years ending on or after December 15, 2006, in annual reports, registration statements, proxy statements or information statements that are required to include executive compensation disclosure.

We recommend that smaller public companies begin working to comply with these new rules well in advance of the applicable effective dates. Compliance with the new rules will be time consuming and will require the attention of the board, compensation committee and management. Smaller public companies should immediately contact their securities counsel and accountants to discuss the impact of the new rules on their company and steps that should be taken to ease the transition into full compliance.

RMF
RUSKINMOSCOUFALTISCHEK P.C.
Smart Counsel. Straight Talk.
East Tower, 15th Floor
1425 Reckson Plaza, Uniondale, NY 11556-1425
New York City ▼ Uniondale ▼ Hauppauge
516.663.6600 ▼ www.rmfpc.com