

SECURITIES PRACTICE GROUP

**WHAT YOU SHOULD KNOW ABOUT
THE SEC'S EXECUTIVE COMPENSATION PROPOSALS
AND WHAT YOU CAN DO NOW TO PREPARE**

On January 27, the SEC released proposed rules that, if adopted, will require substantial changes in the format and scope of executive and director compensation disclosure in reports and forms filed with the SEC. These new rules are expected to be adopted later this year and would be effective for Form 10-Ks for fiscal years ending 60 days or more after publication and for proxy statements that are filed 90 days or more after publication. Companies with calendar year-end fiscal years will not have to comply with the new rules until the 2007 proxy season, but companies whose fiscal years end sometime during 2006 may have to comply with the new disclosure rules this year, depending on the date the proposed rules are adopted.

Because the proposed rules will require more than simply updating previous disclosures, the SEC's Division of Corporation Finance is recommending that all companies start to prepare for complying with the new rules now. According to John W. White, Director of the SEC's Division of Corporation Finance, companies should begin to prepare by making sure that they actually *know the relevant information* related to their executives' compensation and *begin revising disclosure controls and procedures* so as to position themselves to fully and faithfully comply with any new requirements.

KNOWING YOUR COMPANY

The following is an overview of the proposed rules, including some suggestions on how to prepare the new disclosures:

Compensation Discussion and Analysis

A proposed Compensation Discussion and Analysis (CD&A) section would replace the current

compensation committee report required in proxy statements. It is intended to give shareholders more insight into executive compensation policies and procedures from the viewpoint of the compensation committee, including the involvement of executive officers in setting compensation. In the CD&A, companies will be required to address the objectives of their compensation policies, analyze each element of compensation and explain how the amount of each was determined. The CD&A will be subject to the liability provisions (and the CEO and CFO certification requirements) of the Securities Act of 1933 and the Securities Exchange Act of 1934. Management and compensation committees should be aware that decisions made in 2006 may have to be described in next year's proxy statement in conformance with these new rules. Accordingly, compensation committees should start considering how decisions made this year will affect next year's proxy statement disclosure under the proposed rules and how shareholders will react to the new disclosure. Note that under the proposed rules, small business issuers will not be required to provide the CD&A.

Named Executive Officer

The proposals contain a new definition of "named executive officer" that will automatically include the CEO and the CFO, *in addition* to the three most highly compensated officers. Because the determination of who will be a named executive officer will be made on the basis of each officer's total compensation (a new disclosure item described below), companies should also be aware that their named executive officers may be different than in previous years.

Perquisites

The minimum level for disclosure of perquisites is proposed to be reduced from \$50,000 to \$10,000. In addition, the proposals require more highly-detailed disclosure surrounding perquisites and make clear that, in the SEC's view, the value of perquisites for tax purposes is not necessarily the same as the amount to be reported in the proxy statement. Tax "gross-ups" or other reimbursements of taxes owed with respect to any compensation, including perquisites and other personal benefits, would be separately quantified and identified in a new "tax reimbursement" category in the summary compensation table.

Director Compensation Table and Director Share Ownership

Under the proposed rules, detailed information on director compensation will be disclosed for the first time in tabular format. In addition, the stock ownership of directors will be required to be disclosed, along with beneficial ownership through options, and companies will have to disclose any requirement that directors own "qualifying shares."

"Total Compensation" Column

If adopted, the new rules would require companies to report a new figure in the summary compensation table—*total* compensation awarded to, earned by or paid to each named executive officer. This number will also determine the named executive officers for purposes of executive compensation disclosure. The Division of Corporation Finance and compensation consultants recommend that companies use tally sheets to derive this information. For instance, many companies are already preparing spreadsheets that list all aspects of an officer's compensation in a format that can be easily calculated for an officer's total compensation. This tally sheet can be used by a compensation committee to assist it in evaluating total compensation packages for executives.

Dollar Value of Equity Compensation

Currently, companies report the value of equity compensation in terms of the number of shares owned by named executive officers. The proposed compensation tables will require presentation of the dollar value of all stock options, stock appreciation rights and stock awards measured as of the grant date fair value and computed according to SFAS 123(R).

Restricted Stock Awards and Gains (Realized or Not) on Equity Awards

Both restricted stock awards and annual increases in the value of equity awards will be prominently displayed under the proposed rules.

Compensation Consultants

For the first time, companies will have to disclose the use of compensation consultants, including the name of the consultants and whether the consultants are responsible to management, the compensation committee, or both.

Non-Executive Officer Compensation

Under the proposed rules, companies must disclose the compensation and positions of up to three non-executive officer employees whose total compensation exceeds that of any named executive officer. Although the names of such individuals need not be disclosed, their identity will likely be obvious by people familiar with the company.

DISCLOSURE CONTROLS

The Division of Corporation Finance is also encouraging companies to review and to determine the adequacy of their disclosure controls and procedures in light of the proposed revisions to executive compensation disclosure. In considering whether their controls and procedures need modifications, companies should think about the following:

- Who will collect and aggregate additional information which may not be required under existing disclosure requirements?
- Who will be responsible for maintaining the information, analyzing it and ensuring that the CD&A is drafted correctly and clearly?
- Are existing disclosure committees staffed with the right people to undertake the task of revising compensation disclosure?

Like the executive compensation section in proxy statements, these disclosure controls and procedures must be certified by the CEO and CFO in quarterly and annual reports.

SUMMARY

The proposed rules on executive compensation disclosure demonstrate the SEC's intent to give investors a more comprehensive understanding of executive compensation and the key financial relationships among companies and executive officers and directors. Although not yet adopted, the rules are expected to be adopted later this year and apply to companies' next proxy seasons. The Division of Corporation Finance at the SEC is encouraging companies to move through the remainder of this year with an eye toward the next, preparing to collect and disclose the new information and consider the implications of the new disclosure rules on investor perceptions.

Companies seeking more specific information on the SEC's guidance should refer to the proposed rules at www.sec.gov/rules/proposed/33-8655.pdf. If you have any questions, please contact David Braswell, Jill Newbold or your regular Armstrong Teasdale LLP contact.

DAVID W. BRASWELL
One Metropolitan Square, Suite 2600
St. Louis, Missouri 63102
314.552.6631
dbraswell@armstrongteasdale.com

JILL R. NEWBOLD
One Metropolitan Square, Suite 2600
St. Louis, Missouri 63102
314.259.4720
jnewbold@armstrongteasdale.com

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St. Louis, MO
One Metropolitan Square
St. Louis, Missouri 63102
(314) 621-5070

Jefferson City, MO
3405 West Truman Boulevard
Jefferson City, Missouri 65109
(573) 636-8394

Kansas City, MO
2345 Grand Boulevard
Kansas City, Missouri 64108
(816) 221-3420

Overland Park, KS
7400 West 132nd Street
Overland Park, Kansas 66213
(913) 814-0969

Belleville, IL
23 South First Street
Belleville, Illinois 62220
(618) 397-4411

Edwardsville, IL
241 North Main Street
Edwardsville, Illinois 62025
(618) 655-4004

Las Vegas, NV
701 North Green Valley Parkway
Henderson, Nevada 89074
(702) 678-5070

Washington, DC
1747 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 454-2800

Shanghai, China
1376 Nan Jing Xi Lu
Shanghai Centre - Suite 718
Shanghai 200040
P.R. China
011-8621-6279-8808