

MEMO# 19738

February 13, 2006

SEC Proposes Extensive Changes to Rules Governing the Disclosure of Executive and Director Compensation

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [19738] February 13, 2006 TO: SEC RULES COMMITTEE No. 8-06 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 4-06 SMALL FUNDS COMMITTEE No. 4-06 RE: SEC PROPOSES EXTENSIVE CHANGES TO RULES GOVERNING THE DISCLOSURE OF EXECUTIVE AND DIRECTOR COMPENSATION The Securities and Exchange Commission has published for comment proposed revisions to its rules governing disclosure of executive and director compensation, related party transactions, and corporate governance matters.¹ A brief summary of the proposed rules is provided below. ² The provisions that would affect disclosures by registered investment companies ("funds") are highlighted in the last section of the summary. Comments on the proposed rules are due on or before April 10, 2006. We will hold a conference call on Wednesday, February 22nd, at 2:00 p.m. Eastern time to discuss the Release. The dial-in number for the call is (877) 917-6904 and the pass code is 29648. Please send an e-mail to Stephanie Holly at sholly@ici.org to let us know if you plan to participate on the call. Disclosure of Executive and Director Compensation (pp. 14-101 of the Release) Executive and director compensation is currently disclosed through the use of formatted tables that categorize the various elements of compensation. According to the Release, although the tables promote comparability of the disclosure from year to year and from company to company, the Commission believes that they do not always inform investors adequately as to all elements of compensation, particularly in light of the complexity of and variation in compensation programs. The proposed rules, which the Commission says represent a "thorough rethinking" of the current ¹ SEC Release No. 33-8655, 34-53185 and IC-27218 (Jan. 27, 2006) ("Release"). The Release is available on the SEC's website at <http://www.sec.gov/rules/proposed/33-8655.pdf>. The page numbers in this memorandum refer to the Release as printed from the SEC's website. ² The Release requests comment on a wide range of issues. This memorandum briefly summarizes only those requests for comment that could impact funds. ² requirements, would expand the tabular disclosure and require that it be accompanied by narrative disclosure necessary to understand the information presented in the tables. The narrative disclosure must be written in plain English. The new requirements are intended to be comprehensive, so that all elements of compensation are disclosed, and sufficiently broad, so that they will operate effectively as new forms of compensation are developed in the future. Disclosure regarding executive compensation would begin with a new Compensation Discussion and Analysis (CD&A), which is intended to provide material information about the company's compensation

objectives and policies and to put into perspective all other compensation disclosures. The Release provides several examples of issues that would be potentially appropriate for discussion in the CD&A. The CD&A would be filed with the Commission and thus subject to the general disclosure and liability provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The CD&A would be followed by tables and narrative disclosure covering these areas:

- Total compensation for each of the last three fiscal years
- Information about the various elements of compensation (e.g., salary, bonus, stock awards) paid to the company's principal executive officer, principal financial officer, and the three next highest-paid executive officers would be provided in a revised Summary Compensation Table. Among other changes, that table would include a new column showing the total compensation paid to each executive. Separate tables would provide more detailed information about equity awards made to the named executive officers during the last year. The narrative disclosure accompanying this section would have to include, among other things, the total compensation paid in the last fiscal year to up to three employees who were not executive officers during the period but whose total compensation exceeded that of any of the named executive officers. These employees would not be identified by name but by job description.
- Exercises and holdings of previously awarded equity
- Two new tables would report, for each named executive officer, information about (1) the value of all equity awards that remain outstanding as of the end of the fiscal year and (2) amounts received during the fiscal year upon the exercise of options or the vesting of stock or similar instruments.
- Post-employment compensation
- According to the Release, the proposed rules include significant revisions to the disclosure of post-employment compensation. Two new tables would report, for each named executive officer, (1) estimated annual retirement payments under defined benefit plans and (2) contributions, earnings, and balances under nonqualified defined contribution and other deferred compensation plans. Narrative disclosure would be required, among other things, to detail the potential payments and benefits to a named executive officer upon his or her termination or upon a change in control of the company.

3 According to the Release, because of the complexity now seen with director compensation packages, the proposed rules include a new Director Compensation Table (modeled on the Summary Compensation Table discussed above) that would disclose, for each director, total compensation information for the most recent fiscal year. Outstanding equity awards would be disclosed in a footnote to the table. In the compensation tables for executives and directors, the amount of perquisites above \$10,000 would need to be included in the column for "all other compensation." The Release provides interpretive guidance on the factors to be considered in determining whether an item is a perquisite that must be disclosed. Business development companies ("BDCs") would have to comply with the same disclosure requirements as operating companies with regard to executive and director compensation. The Release requests comment on, among other things, whether (1) BDCs should be required to comply with the same compensation disclosure requirements as operating companies or funds, a combination of the two, or some other set of disclosure requirements and (2) the Commission should require disclosure of certain compensation paid by the fund complex that includes a BDC. Compensation Disclosures on Form 8-K (pp. 101-113 of the Release) Currently, Item 1.01 of Form 8-K requires disclosure about a company's entry into, or amendment or termination of, a material definitive agreement entered into outside the ordinary course of business. According to the Release, the 2004 amendments to Form 8-K extended this requirement to many agreements regarding executive compensation, which has had the effect of requiring companies to make real-time disclosure about compensation arrangements that do not always appear to be unquestionably or presumptively material. Under the proposed rules, employment compensation arrangements would no longer be subject to the requirements of Item 1.01; instead, disclosure of such arrangements would

be combined into Item 5.02, which currently requires disclosure regarding the appointment or departure of specified officers or directors. In particular, revised Item 5.02 would include, among other things: (1) a brief description of any material plan or arrangement that is entered into or materially amended in connection with the appointment or departure of a specified officer or director, or any grant or award to that person in connection with his or her appointment or departure; and (2) with respect to any named executive officer, a brief description of any new material compensation plan or arrangement (or material amendment thereto), or a grant under such plan or arrangement, that is not related to the officer's appointment or departure. With respect to the disclosure noted in (2), the proposed rules would provide a safe harbor from liability under Exchange Act Rule 10b-5 for failure to make a timely filing.

Related Party Transactions (pp. 115-137 of the Release) The proposed rules include significant revisions to the disclosure requirements for related party transactions, which the Release states are designed to streamline the requirements and make them more 4 principles-based. In general, a company would be required to disclose any transaction since the beginning of the last fiscal year, or any transaction currently proposed, in which: (1) the company is a participant, (2) the amount involved exceeds \$120,000, and (3) any related person had, or will have, a direct or indirect material interest. This requirement would extend to disclosure of indebtedness, thus eliminating the current distinction between the disclosure requirements for indebtedness and other types of related party transactions. A company also would be required to disclose its policies and procedures for the review, approval or ratification of related party transactions and to identify any reportable transaction for which the policies and procedures either did not require review or were not followed.

Director Independence and Corporate Governance (pp. 137-145 of the Release) The proposed rules would consolidate and expand the disclosure requirements regarding director independence and corporate governance. Among other things, a company would be required to identify its independent directors and to describe, for each such director, any transactions (other than any related party transaction already required to be disclosed), relationships, or arrangements that were considered by the company's board of directors in determining that the director is independent. The definition of independence that is applied must comply with the listing standards applicable to the company or, if the company is not a listed issuer, with the independence standards of a national securities exchange or national securities association as specified by the company. If the applicable standards also contain independence requirements for board committees, the company would be required to identify each non-independent member of the compensation, nominating, and audit committees. Under the proposed rules, a company would be required to disclose information about its compensation committee similar to that currently required for its nominating and audit committees. This disclosure would include the role of any executive officers in determining or recommending the amount or form of executive or director compensation.

Provisions Affecting Registered Investment Companies (pp. 149-151 of the Release)

- **Compensation disclosures on Form 8-K** – The proposed revisions to Form 8-K that are described above would apply to closed-end funds.
- **Proxy disclosure requirements** – The proposal would reorganize the provisions in Schedule 14A concerning fund disclosure relating to nominating and audit committees, board meetings, the nominating process, and shareholder communications. Specifically, these matters would be moved from Item 7 into Item 22(b). The substance of these requirements would not change. The Release requests comment on whether the proposed reorganization is appropriate or, if not, how it should be reorganized. It also requests comment on whether any substantive changes should be made.
- 5 The proposal also would revise Item 22(b) to include disclosure regarding nominating and audit committee independence that is similar to that already required by Item 7.
- **Disclosure of director interests, transactions and relationships** – The proposal would raise from \$60,000 to \$120,000 the threshold for

disclosure in proxy statements and registration statements of certain interests, transactions, or relationships involving each independent director. This change would correspond to the proposed increase in the threshold for disclosure of related party transactions involving directors of operating companies, as described above. The Release requests comment on whether a higher or lower threshold, or none at all, would result in more effective disclosure. It also requests comment on whether the threshold should operate on a sliding scale to capture smaller transactions for smaller funds. • Portfolio manager compensation – Currently, a fund is permitted to exclude relocation plans and arrangements from its description of the structure of portfolio manager compensation, provided that they do not discriminate in scope, terms, or operation in favor of the portfolio manager or a group of employees including the portfolio manager and are available generally to all salaried employees. The proposed rules would end this exclusion, mirroring the elimination of a similar exclusion for operating companies. According to the Release, even when relocation benefits are generally available to all salaried employees, they are susceptible to operation in a discriminatory manner, and exclusion may deprive investors of disclosure of significant compensation benefits. The Release requests comment on whether funds should also be required to describe the following as compensation to portfolio managers: group life, health, hospitalization, medical reimbursement, and pension and retirement plans and arrangements. Rachel H. Graham Associate Counsel