

Client Alert

An informational newsletter from Goodwin Procter LLP

SEC Amends Related Person Transaction, Corporate Governance and Form 8-K Disclosure Requirements

Introduction

The Securities and Exchange Commission recently published final rules that will effect sweeping changes in its disclosure requirements for executive compensation. These are summarized in Goodwin Procter's *Client Alert* "SEC Adopts Sweeping Changes to Executive Compensation Disclosure Rules" at www.goodwinprocter.com/getfile.aspx?filepath=/Files/Publications/CA_CompensationDisclosureRules_9_11_06.pdf, which we are circulating with this Client Alert. This Client Alert summarizes a variety of other rules that were adopted by the SEC at the same time. These new rules will change disclosures concerning transactions with related persons, corporate governance matters, Form 8-K reporting of executive compensation matters, and pledges of company securities by executive officers and directors.

The new rules apply to Form 10-K reports for fiscal years ending on or after December 15, 2006 and to proxy and information statements and registration statements filed on or after December 15, 2006 that are required to include executive compensation disclosure for fiscal years ending on or after December 15, 2006. The changes in the Form 8-K requirements will be effective for events that occur on or after November 7, 2006. Additional information on effective dates and compliance is contained in the section captioned "Effective Dates" at the end of this Alert. The text of the SEC release adopting the final rules is available on the SEC Web site at www.sec.gov/rules/final/2006/33-8732.pdf.

(Please also see our Observations and Practical Tips throughout this Client Alert and our Summary of Key Changes at the end of this Client Alert.)

Related Person Transactions

The new rules governing disclosure of company transactions with related persons, which include directors, director nominees, executive officers, 5% stockholders and their respective immediate family members and other persons sharing their households, are intended to complement the new executive compensation rules. The new rules change some of the standards governing which transactions must be disclosed, require new disclosure of the company's policies and procedures for the review, approval or ratification of related person transactions, and make other technical changes to the current rules.

Transactions with Related Persons

The new rules largely retain the existing principles for disclosure of related person transactions, but reflect the SEC's goal of making disclosure of related person

transactions more principles-based and focused on materiality rather than bright line disclosure tests. The new rules will require disclosure of:

- any transaction or series of transactions, including indebtedness, since the beginning of the company's last fiscal year, or any currently proposed transaction,
- in which the company was or is to be a participant,
- in which the amount involved exceeds \$120,000, and
- in which any related person had or will have a direct or indirect material interest.

The primary changes from the current rules are an increase in the dollar threshold for disclosure from \$60,000 to \$120,000 and the elimination of current rules that require disclosure of certain business relationships with entities in which directors or director nominees serve as an executive officer or own an equity interest that exceeds 10%. Additionally, and perhaps more importantly, the new rules eliminate current SEC guidance that permits non-disclosure of relationships with such entities that are below a specified dollar amount as long as the director or director nominee did not receive any special benefits as a result of the relationship. Because many business relationships with entities in which directors or director nominees serve as an executive officer or directly or indirectly own an equity interest that exceeds 10% involve amounts in excess of \$120,000, companies will now be required to assess the materiality of these relationships without the benefit of the SEC's bright line tests.

Procedures for Approval of Related Person Transactions

The new rules will require companies to describe their policies and procedures for the review, approval or ratification of reportable transactions with related persons. The description must include the material features of these policies and procedures. Although the material features will vary, examples may include, among others:

- the types of transactions that are covered and the applicable standards;
- the persons or groups of persons on the board of directors responsible for applying the policies and procedures; and
- whether these policies and procedures are written or, if not, how such policies and procedures are evidenced.

The new rules will require companies to identify any transaction that would be required to be disclosed as a related person transaction where the transaction was not subject to the company's policies and procedures or where those policies and procedures were not followed.

Observations and Practical Tips

Companies should update their current policies and procedures regarding related person transactions to ensure that they reflect the new rules. This is particularly true for Nasdaq and Amex listed companies, whose audit committees are required by exchange rules to approve all related person transactions. Companies that have not already established written policies and procedures for the review and approval of related person transactions should consider doing so. Because the new rules eliminate some of the clearly delineated exceptions and have a greater focus on more subjective materiality judgments, companies may also wish to consider whether, as a part of these policies and procedures, certain types of related person transactions should be either preapproved or

deemed to be immaterial on a categorical basis. For the same reasons, the new rules may affect whether a director qualifies as a “non-employee director” under Section 16 of the Securities Exchange Act. To be sure that equity-based awards authorized by a board’s compensation committee still qualify for the exemption from short-swing profit liability under Rule 16b-3, companies should confirm that the new rules will not disqualify any compensation committee members from “non-employee director” status.

Corporate Governance

The new rules include corporate governance disclosure requirements that will consolidate current requirements regarding director independence, board and committee meetings, the company’s audit, nominating and compensation committees, compensation committee interlocks and shareholder communications. In addition, the new rules update current disclosure requirements about director independence and require new disclosure about the company’s compensation committee.

Director Independence

The new director independence disclosure rules reflect both the SEC’s current requirements and the current listing standards of the national securities exchanges. The new rules will require:

- disclosure of whether each director who served at any time during the past year and each director nominee is independent under the applicable listing standards defining board independence, including disclosure regarding any exemptions from applicable independence requirements used by a company (*e.g.*, exemptions for controlled companies under Nasdaq and Amex rules); and
- a description, by specific category or type, of any transactions, relationships or arrangements not otherwise disclosed that were considered by the board in determining that a director or director nominee is independent (the new rules do not require specific details of each such relationship, but the description of the category or type must be sufficiently detailed so that the nature of the relationship is readily apparent).

Companies that have adopted their own definitions of independence for directors and committee members (such as categorical standards of independence established under the NYSE rules) must disclose whether those definitions are posted on the company’s Web site and, if not, those definitions must be included as an appendix to the company’s proxy statement at least once every three years or if the definitions have been materially amended since the company’s last fiscal year.

Observations and Practical Tips

The new rules will highlight the continued focus on the independence of directors. In light of the new rules requiring disclosure of all relationships with independent directors that were considered by the board in making determinations of independence, companies should review their current procedures for gathering the relevant information necessary both to facilitate independence determinations by the board and to comply with disclosure requirements after these judgments are made. Additionally, companies that have not already adopted categorical standards of director independence may want to consider doing so in order to limit the number of relationships that must be specifically considered by the board in making independence determinations.

Compensation Committee

The new rules will require disclosure regarding the compensation committee that is similar to the disclosure currently required for audit and nominating committees, such as whether the compensation committee has a charter and, if so, making the charter available either through the company's Web site or proxy materials. If the company does not have a standing compensation committee, the company will be required to state the basis for the view of the board of directors that it is appropriate not to have such a committee, and to identify each director who participates in the consideration of executive and director compensation.

In addition, the company will be required to provide a narrative description of the processes and procedures used by the compensation committee (or persons performing the equivalent functions) for considering and determining executive and director compensation, including:

- the scope of authority of the compensation committee;
- the extent to which the compensation committee may delegate any authority to other persons, specifying what authority may be so delegated and to whom;
- any role of the company's executive officers in determining or recommending the amount or form of executive and director compensation; and
- any role of compensation consultants in determining or recommending the amount or form of executive and director compensation.

The required disclosure regarding compensation consultants must include the identity of such consultants, a statement as to whether the consultants are engaged directly by the compensation committee or any other person, a description of the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement. The new rules will not require companies to identify the executive officers that the compensation consultants have contacted as initially proposed by the SEC.

Observations and Practical Tips

The new rules requiring disclosure about compensation committees will focus on the corporate governance structures that companies have established for considering and determining executive and director compensation. This narrative discussion should not be confused with the new Compensation Discussion and Analysis section, which will focus on the company's compensation policies and objectives and provide context for the tabular executive compensation information in the proxy statement. In contrast, the corporate governance disclosure relates to the authority of the compensation committee, how it exercises this authority, the role of management in the compensation process, and the role of compensation consultants and the nature of their engagements.

With these new disclosure requirements taking effect shortly, companies should review their current corporate governance procedures now to determine if changes are appropriate. Companies should also take the opportunity to review the compensation committee's charter and to consider whether existing informal procedures should be formalized. While a compensation committee cannot do its job without delegating tasks to, and receiving input from, management and other advisors, the new rules suggest an increased focus on clearly delineating the roles of committee members, management and

outside consultants in the company's process for determining executive and director compensation. These new disclosure requirements will also provide companies with an opportunity to revisit their corporate governance processes regarding executive compensation in light of the lessons learned from the *Disney* litigation as described in Goodwin Procter's August 9, 2006 *Client Alert* "Practical Tips for Directors Post-Disney" available at www.goodwinprocter.com/getfile.aspx?filepath=/Files/Publications/CA_AdviceAfterDisney_8_9_06.pdf.

Pledges by Officers and Directors

The new rules require companies to disclose whether any equity securities beneficially owned by directors, director nominees and executive officers have been pledged.

Observations and Practical Tips

Companies may wish to revise their insider trading policies to specifically address pledges of company securities by executive officers and directors, if pledges are not already addressed. In addition, companies that do not currently track whether executive officers and directors have pledged company securities should begin doing so in order to ensure that their disclosure controls and procedures remain effective as required by SEC rules.

Revised Form 8-K Disclosure Requirements

The 2004 SEC amendments to its Form 8-K requirements significantly increased the number of filings related to executive compensation. Under current rules, companies must file a Form 8-K report within four business days after entering into or materially amending an employment agreement or other compensation arrangement with a director or named executive officer, or with any other executive officer unless the agreement or arrangement is immaterial in amount or significance. One of the SEC's objectives in adopting these amendments was to eliminate Form 8-K reporting of compensatory arrangements that are not "unquestionably or presumptively material."

Under the new rules, Item 1.01 of Form 8-K, which will continue to apply to other material definitive agreements, will no longer apply to executive or director compensation arrangements. Item 5.02 will be expanded to include reporting of material compensation arrangements involving named executive officers, certain other "principal" officers and directors.

As amended, Item 5.02 will require companies to include additional information regarding material employment compensation arrangements involving named executive officers that were previously reported under Item 1.01. The principal changes in the Form 8-K reporting requirements include the following:

- expanding the persons for whom information regarding retirement, resignation or termination is required to include all persons who were named executive officers for the company's previous fiscal year, in addition to the "principal" officers and directors for whom disclosure is currently required;
- requiring disclosure of any material plan, contract or arrangement entered into, and any grant or award made, or any material amendment or modification, in connection with the appointment of a new principal officer or election of a new director, instead of the current requirement that applies only to the terms of any employment agreement with such persons; and

- requiring disclosure of any material plan, contract or arrangement adopted, and any grant or award made, as well as any material amendment or modification, involving the company's principal executive officer, principal financial officer or any person who was a named executive officer for the company's prior fiscal year.

In the case of each of these disclosure items, the SEC emphasized that only a brief description of the specified matter is necessary under the amendments. Disclosure of grants and awards will not be required if they are materially consistent with the terms of previously disclosed plans, agreements or arrangements and the grant or award is subsequently included in the company's annual executive compensation disclosure.

The new rules will extend the existing limited safe harbors for antifraud liability and Form S-3 eligibility for late filings of specified Form 8-K disclosure items to include Item 5.02 disclosure of material compensatory plans, contracts, arrangements, grants and awards, and material amendments or modifications, with or to a person who was a named executive officer.

Observations and Practical Tips

In general, the amendments to the Form 8-K reporting requirements should simplify the process of preparing Form 8-K reports relating to executive compensation arrangements involving named executive officers, as well as potentially reduce the number of such reports. However, companies should review and adjust where necessary their disclosure controls and procedures in light of the amended reporting requirements to ensure that reportable events are tracked and that the required disclosure is included in Form 8-K reports on a timely basis.

Effective Dates

Companies must comply with the amended SEC disclosure requirements as follows:

- *Form 8-K reports*: for triggering events that occur on or after November 7, 2006;
- *Form 10-K reports*: for fiscal years ending on or after December 15, 2006;
- *Proxy or information statements*: filed on or after December 15, 2006 that are required to include executive compensation and related person transaction disclosure for fiscal years ending on or after December 15, 2006; and
- *Securities Act and Securities Exchange Act registration statements (including pre-effective and post-effective amendments)*: filed with the SEC on or after December 15, 2006 that is required to include executive compensation and related person transaction disclosure for fiscal years ending on or after December 15, 2006.

The SEC amendments will apply prospectively and therefore, where applicable, will phase in over the next three fiscal years. As a result, following the effectiveness of the new rules, companies will not be required to include related person disclosures for fiscal years ended before December 15, 2006 (although these disclosures may still be required in companies' financial statement footnotes). The SEC is expected to issue interpretive guidance that will permit companies to voluntarily comply with the new rules (other than the Form 8-K rules) before the compliance dates above at any time after November 7, 2006. Companies that elect to do so must comply with all of the new rules (executive

compensation, related person transactions, corporate governance and the other new rules).

This Client Alert is intended to cover the final rules that are applicable to domestic public companies, other than small business issuers. The applicability of the new rules and their effective dates may vary for other companies, such as small business issuers, foreign private issuers and investment companies. Please contact your regular Goodwin Procter attorney or any of the individuals listed at the end of this Client Alert for information on how the new rules will affect these companies.

Summary of Key Changes

<i>Subject</i>	<i>Summary of New Requirements</i>	<i>Next Steps & Practical Suggestions</i>
Related Person Transactions (pp. 1-3)	<ul style="list-style-type: none"> • revised standards regarding which transactions must be disclosed • requires disclosure of policies and procedures for approving related person transactions 	<ul style="list-style-type: none"> • identify related person transactions under new rules • review current policies or establish new policies for approval of related person transactions, ideally in writing, to ensure the company gathers information necessary for review and disclosure
Director Independence (p. 3)	<ul style="list-style-type: none"> • requires description of relationships the board considered in evaluating independence 	<ul style="list-style-type: none"> • review current policies to ensure the company gathers the necessary information • document discussions of independence to facilitate disclosure • consider adopting categorical standards of director independence
Compensation Committee (pp. 4-5)	<ul style="list-style-type: none"> • requires disclosure of the processes and procedures used by the compensation committee for determining director and executive compensation • requires detailed disclosure of information regarding the use of consultants by the compensation committee 	<ul style="list-style-type: none"> • review current corporate governance policies and compensation committee charter in light of new rules • consider retaining a compensation consultant to report directly to the compensation committee • keep careful track of the directions given to consultants to facilitate disclosure
Pledges by Officers and Directors (p. 5)	<ul style="list-style-type: none"> • requires disclosure of shares pledged by executive officers, directors and director nominees 	<ul style="list-style-type: none"> • begin tracking pledged securities by executives, directors and potential director nominees • review or adopt insider trading policy provisions concerning pledges

The securities and corporate finance attorneys at Goodwin Procter keep current on these matters. We are available to help advise public companies and their officers and directors on specific issues as well as to provide educational presentations to help them understand and meet their responsibilities under both current and proposed rules and regulations. Please contact your regular Goodwin Procter attorney or any of the individuals listed below if we may be of assistance.

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