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2004 Year-End Regulatory Changes Spur 2005 Board Action

By Mark Rosen

Many corporate boards found themselves faced with major policy decisions at their 2004 year-end meetings in regard to executive compensation programs, without yet knowing the outcome of imminent changes in several key regulatory areas. The regulatory environment has now cleared. If they postponed decisions pending release of final rules, they should act now based on the new environment.

What Happened?

Three recently approved regulatory changes will profoundly impact the design and administration of executive compensation programs. Two changes were announced only in the last weeks of 2004, after most boards and committees had held their final meetings for the year:

- On December 16, 2004, after more than a year of consideration, the Financial Accounting Standards Board (FASB) issued final fair-value accounting rules mandating that companies expense the cost of stock options beginning with financial statements issued after June 15, 2005. This new pronouncement dictated how options should be expensed and also changed the accounting for other stock-settled equity incentive programs, giving a number of instruments new, more favorable treatment.
- On December 20, 2004, the IRS issued guidance on the deferred compensation provisions of the American Jobs Creation Act of 2004 (AJCA), passed by Congress and signed by President Bush in October 2004. (Section 409A of the Internal Revenue Code.)
- In November 2004, the SEC issued a long-awaited FAQ on Form 8-K "real-time" disclosure rules that had become effective in August, which mandate more timely filings of 8-Ks for changes in compensation-related matters.

Each of these legislative and regulatory changes will have a major impact on the design, cost, and use of many executive compensation vehicles.

What Does It Mean?

Initial responses to the above regulatory changes by many companies have been relatively conservative:

- Limited disclosure.
- The granting of full value shares in place of stock options.
- Amendments to compensation arrangements to comply with section 409A.
- Scale-back of stock option grants.

However, the new regulatory environment presents boards with an opportunity to make far-reaching and meaningful changes to executive compensation programs and address what critics have targeted as corporate governance shortcomings in many plans.

Option Expensing

The most far-reaching change for many companies is FASB's finalization of its rules for the expensing of stock options which, in conjunction with additional changes to the accounting for other equity instruments, will have the immediate effect of equalizing the accounting costs of options versus vehicles that use full-value shares. When faced with a financial statement cost, we believe that many companies will seek efficient forms of equity awards to reduce the expense and the number of shares used, while providing employees with motivational equity incentives that they will value going forward. Numerous companies altered their equity practices in 2003 and 2004 in anticipation of the FASB change,

Director Summary: A compensation expert reviews recently revised governance and accounting rules and says compensation committees that have postponed decisions must act now based on the new environment.

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usually by retreating in part or full from options to the use of full value shares or performance shares. Some broad-based equity grant programs were scaled back or eliminated, including employee stock purchase plans, which under the new rules will entail greater expense.

The new accounting treatment for stock options has triggered a significant transition issue—and opportunity—for many companies. When the new accounting standard takes effect, all unvested options will acquire an accounting expense until the end of their vesting period. Because the belief that underwater options have little retentive or incentive value, coupled with the fact that unvested options will trigger an earnings charges, several dozen companies have chosen to avoid future earnings charges by accelerating vesting of underwater options, a trend that has drawn some attention in governance circles and from the media.

Happily, the final FASB rules, as written, will allow for considerable flexibility and creativity in restructuring equity programs. With all major stock incentive vehicles now on a level playing field with regard to earnings charges, companies have the opportunity to consider using a mix of performance-based stock instruments. Key issues to consider include:

- Cost versus benefit.
- The organization's culture, long-term goals, and executive compensation philosophy.
- The efficiency and risk-adjusted return of the various available equity instruments.

Alternative equity instruments include:

Stock-settled stock appreciation rights (SARs). These provide grantees with the spread between the grant date market value of the underlying stock (the strike price) and the exercise date market value of the underlying stock.

Performance shares. A certain number of shares of stock are granted in the future if performance measures are met.

Time-based restricted stock. A fixed number of shares of stock are vested upon completion of a future service period.

Performance-accelerated restricted stock (PARS). The vesting of restricted stock is accelerated based on the achievement of performance goals.

Performance-based/premium options. Options are granted with strike prices greater than the stock's fair market value on the date of grant, or the option only vests if performance measures are met.

Combination awards. More than one instrument (stock options and restricted stock for example) are granted together.

We believe that many companies will choose a combination of awards, most commonly stock options/stock-settled SARs and some flavor of full value share (restricted stock/performance-accelerated restricted stock or performance shares).

American Jobs Creation Act of 2004 (AJCA)

The creation of Internal Revenue Code section 409A under the AJCA broadly defines "nonqualified deferred compensation" and makes it currently taxable unless certain requirements are met. The IRS has now issued the first installment of what is expected to be a series of guidance on the scope and application of the new rules.

In addition to clarifying the treatment and allowable practices for traditional deferred compensation, the new rules apply to other compensation programs including provisions for equity grants and terms of employment agreements, which must now be reviewed for compliance. For example, the new law applies to discounted stock options, cash-settled SARs, certain arrangements between partners and partnerships, and severance payments. Options and SARs granted before 2005 with discounted strike prices or deferral features pose a particularly tough transition problem.

Although many companies scrambled to make amendments before the close of 2004, the IRS ultimately approved relatively lenient transition rules that allow companies until the end of 2005 to bring plans into compliance. Boards that took pre-emptive action need to review such actions to ensure compliance with the recently released transition guidance. As with any plan changes, directors also should ensure that deferred compensation arrangements are consistent with the organization's overall compensation philosophy.

While many companies will discover that only minor changes to plan documents and administration are necessary, in other situations the new rules could impose significant administrative burdens. For example, linking qualified and non-qualified plans to ensure that participants maximize their qualified plan contributions with any excesses placed in the non-qualified plan will no

longer be allowed under the new regulations. Failure to amend plans to bring them into compliance, or to operate them in the spirit of the new rules until guidance is complete, may result in significant cost to plan participants as current and past contributions could immediately be subject to taxes and penalties.

Real-Time Form 8-K Disclosure

The new SEC rules on executive compensation are intended to increase the timeliness and breadth of disclosure by requiring timely filings of all significant actions taken in regard to executive and director compensation arrangements. While many of those actions already were disclosed in various company filings, the new mandate calls for a separate filing, within four business days, that will alert shareholders to board actions in "real time."

Disclosure will be made using Form 8-K, a long-standing SEC filing that now will be required much more frequently. A filing may be triggered by a wide range of board or committee actions, including: adopting or changing a plan; setting performance goals; and entering into, terminating, or amending an employment agreement. For example:

- Companies that accelerated the vesting of underwater options in anticipation of FAS 123 generally are concluding that a Form 8-K is required—an action they otherwise might not have chosen to disclose.
- Salary adjustments, when made in the normal course of managing salaries, merit, and cost of living increases, generally should not trigger 8-K disclosure. However, a market adjustment to move an executive to a competitive position based on a peer analysis may require a Form 8-K, even though this information would still be disclosed in the proxy.
- Approval of executive bonuses for 2004 for which the performance goals had not been previously adequately disclosed are now being reported on Form 8-Ks.

Since it went into effect in August 2004, the majority of compensation-related 8-K filings have fallen into the following categories:

- Reporting new equity grants or filing forms of equity grant agreements; under the SEC staff's FAQ, an equity grant consistent with the terms of a previously filed grant agreement does not trigger any further 8-K reporting.
- Setting of performance measures and targets for 2005 annual incentive plans.
- Adoption, modification, or termination of employment agreements.

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- Amendments made to plans to meet the deferred compensation provisions of the AJCA.

To be sure, some boards will take a technical approach to compliance, seeking legal justification to disclose as little as possible. However, given that the new rules clearly reflect a governance trend of increased disclosure that has widespread public and media support, a more prudent rule of thumb would be to err on the side of disclosure.

The Way Forward

Some of the new disclosure requirements will shine a bright light on executive compensation plans and policies. In addition, the FASB has provided a compelling reason to address equity-based long-term incentive plans, and the U.S. Congress has prompted reexamination of the full range of executive benefits, most specifically deferred compensation and supplemental executive retirement plans (SERPs). (Ed Note: For a detailed discussion of SERPs, see *Directors Monthly*, March 2005, at page 18.) These regulatory changes are not isolated events either, but come in the midst of:

- Rising investor activism that is being felt through negative votes on proposed compensation plans, withholding of votes for compensation committee members, and shareholder proposals;
- Calls for improved proxy disclosure of compensation;
- Court challenges to compensation decisions by shareholder litigants and on disclosure issues by the SEC;
- Corporate governance reforms; and
- Fairly harsh commentary in the press.

Boards and committees can and should view this as an opportunity to reexamine their executive compensation and benefits practices from top to bottom—beginning with their philosophy (Ed Note: See the next article) and working right through to the inner workings of their executive incentive and benefit plans, not forgetting overall corporate governance needs. ■

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