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Subject: New SEC Disclosure Requirements For Above-Market Earnings On Deferred Compensation

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In mid-2006, the Securities and Exchange Commission (the "SEC") adopted extensive changes to the rules requiring disclosure of executive and director compensation (the "proxy disclosure rules"). (See our Bulletins Nos. 06-109 and 06-86.) Public companies are subject to the new rules this proxy season (2007) for the first time. Consequently, there are many new requirements that simply are not clear, including the subject of this Washington Report -- the required disclosure of "above-market earnings" under nonqualified deferred compensation plans.

The new proxy disclosure rules generally require that "above-market or preferential earnings" for senior executives under a nonqualified deferred compensation plan must be disclosed in column h of the summary compensation table ("SCT"). Interest is above-market, for purposes of the new rules, only if the rate of interest exceeds 120% of the applicable federal long-term rate, with compounding (as prescribed in Revenue Code section 1274(d)) at the rate that corresponds most closely to the rate under the company's plan at the time the interest rate or formula is set. Footnote or narrative disclosure may be provided to explain the reporting company's criteria for determining that any portion of the earnings is considered to be above-market.

However, the disclosure needn't be made if the interest rate or rate of return is calculated on the same basis as that used by a tax-qualified plan which is broadly available to employees generally, such as a 401(k) plan. Because this is the first year under the new rules, it is not clear how far the SEC staff will allow a company to push the standard "broadly available to employees generally." The staff may be willing to accept nondisclosure only if a reporting company makes a compelling case that the earnings are determined based on a reasonable standard. For example, if a nonqualified deferred compensation plan takes its earnings rate from a large well known mutual fund and the company has a reasonable basis for using the referenced plan or account, the SEC staff may agree with a company's position that it is not above-market. Companies that think they have such a strong basis for nondisclosure should consider a consultation with the SEC staff. Bear in mind that the greater the disparity between interest paid to executives on deferred compensation plans and the rates of return available to employees generally on their benefit plans, the more likely it is that the SEC will insist on disclosure of the amount of the "above-market" earnings in the SCT.

It should be emphasized that this issue only pertains to the required disclosure under the SCT. In contrast, all earnings, not just above-market earnings, must be disclosed in the Nonqualified Deferred Compensation table, which is a required supplemental table following the SCT. Companies are also required to provide narrative disclosure of the major provisions of a plan in connection with the Nonqualified Deferred Compensation table, including the amounts that may be deferred and how the earnings are determined under the plan.

Although all earnings must generally be disclosed under the new proxy rules, companies and other interested parties are specifically concerned about the disclosure of "above-market earnings" under the SCT. For example, many companies feel that above-market earings figures are a misleading indicator of employee compensation. In addition, the calculation of above-market earnings often can be administratively burdensome. In many cases, it may be easier to disclose the entire earnings of all nonqualified plans instead of having to break out only the above market earnings for purposes of the SCT.

During this first proxy season under the new rules, companies are struggling to determine whether their plans provide above-market or preferential earnings that must be disclosed in the SCT. For example, one AALU member has raised a question about how a company should determine whether earnings are above-market or preferential if the plan credits the individual accounts with interest at a rate based on an insurance company's separate account portfolios. We understand that the member's client informally contacted the SEC staff and was told that the concept of "above-market" pertains only to fixed or guaranteed interest rate accounts.

Although each separate circumstance may produce different results, there are some general principles that should be taken into account in determining whether disclosure may be required. To begin with, as a basic defensive measure under the securities laws, it is generally better to disclose than not to disclose. There are no penalties for over-disclosure, but failure to disclose can be a problem if the failure results in a material factual misrepresentation. Furthermore, if the amount of money involved is small and will not cause a misleading distortion of the information presented, the better course of action is usually disclosure. On the other hand, the larger the amount of money involved, the more likely it is that the SEC or a private plaintiff may argue that disclosure is required.

Nevertheless, in this pivotal proxy season, the SEC staff will likely recognize that the rules raise questions for which there are no clear answers. Companies will have to make reasonable, good faith interpretations based on the advice of counsel. To help with this, the SEC staff is encouraging companies and counsel to consult with it in advance of action. Whether your client's particular situation should be exposed to the SEC is a judgment that should, in many -- preferably most -- situations, be referred to counsel.

AALU understands that the SEC staff is planning to review the disclosures from this proxy season and to issue additional guidance in the fall as needed.

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