MINTZ LEVIN
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SECURITIES
ADVISORY

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One Financial Center
Boston, Massachusetts 02111 USA
617 542 6000 | 617 542 2241 fax

701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004 USA
202 434 7300 | 202 434 7400 fax

666 Third Avenue
New York, New York 10017 USA
212 935 3000 | 212 983 3115 fax

707 Summer Street
Stamford, Connecticut 06901 USA
203 658 1700 | 203 658 1701 fax

Water Garden
1620 26th Street
Santa Monica, California 90404 USA
310 586 3200 | 310 586 3202 fax

1400 Page Mill Road
Palo Alto, California 94304 USA
650 251 7700 | 650 251 7739 fax

9255 Towne Centre Drive
San Diego, California 92121 USA
858 320 3000 | 858 320 3001 fax

The Rectory
9 Ironmonger Lane
London EC2V 8EY ENGLAND
+44 (0)20 7726 4000 | +44 (0)20 7726 0055 fax

Please contact the Mintz Levin attorney who is responsible for your corporate and securities law matters if you have any questions or comments regarding this information.

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Preparation for 2006 Fiscal Year SEC Filings and 2007 Annual Shareholder Meetings

As our clients and friends know, each year Mintz Levin provides a summary of the regulatory developments that impact public companies as they prepare for their fiscal year-end filings and annual shareholder meetings. This Memorandum discusses key considerations to keep in mind as you embark upon the year-end reporting process in 2007.[1]

Executive compensation disclosure is the focus of most of the changes for this reporting season. The SEC's new disclosure requirements for executive compensation are in effect for annual reports and proxy statements covering fiscal years ending on or after December 15, 2006, and certain changes in the Form 8-K requirements for executive compensation disclosures took effect on November 7, 2006.[2] The new requirements, including in particular the new Compensation Discussion and Analysis ("CD&A"), have shifted the time frame for preparation of executive compensation disclosures to earlier in the year-end reporting process than ever before, due in part to the increasing number of individuals within and outside companies whose input is required to draft the new disclosures. In addition, the SEC has emphasized repeatedly that principles matter in the preparation of executive compensation disclosures: meaning that, as companies prepare the descriptions of their executive compensation arrangements in the CD&A and in the narratives accompanying the tables, they should keep in mind that all material aspects of their compensation programs need to be discussed, even if there may appear to be no specific rule or table that requires the disclosure.

In addition, companies continue to cope with the rigorous disclosure requirements that accompany internal control reporting obligations under Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). The SEC has recently stated that it has heard the requests of smaller issuers for some relief with respect to Section 404 reporting, and

[1] We invite you to review our memorandum from last year which described regulatory changes that were new for fiscal year 2005 filings, and we would be happy to provide you with another copy upon request.

[2] Our Client Advisories regarding the new executive compensation disclosure rules are available on our website at http://www.mintz.com/publications/detail/546/Securities_Law_Alert_SEC_Amends_Recently_Adopted_Executive_Compensation_Disclosure_Requirements/ and http://www.mintz.com/publications/detail/520/Securities_Law_Advisory_The_SECs_Compensation_Disclosure_Reforms_PrinciplesBased_Disclosure_Arrives_for_Executive_Compensation/, and our Client Advisory regarding the changes to Form 8-K is available on our website at http://www.mintz.com/publications/detail/511/Securities_Law_Advisory_The_SECs_Compensation_Disclosure_Reforms_8K_Disclosure_Requirements/.

has issued proposed interpretive guidance on internal control reporting for those smaller companies, including an approach that will permit a more "scalable and flexible" approach to internal control reviews.[3] This guidance will replace Accounting Standard No. 2 as issued by the Public Company Accounting Oversight Board in June 2004. As noted by the SEC in its press release regarding the interpretive guidance, "…smaller public companies often have less complex internal control systems than larger public companies, [and] this proposed approach would enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances."[4]

We look forward to working with you to make this year's annual reporting process as smooth as possible.

Final (For Now) Phase-In of Accelerated Periodic Report Filing Deadlines

For companies that qualify as large accelerated filers as of their fiscal years ending on or after December 15, 2006, annual reports on Form 10-K are now due 60 days after fiscal year-end (Thursday, March 1, 2007 for December 31 year-end companies).[5] Form 10-K reports continue to be due 75 days following fiscal year-end for accelerated filers[6] (Friday, March 16, 2007 for December 31 year-end companies) and 90 days after fiscal year-end for non-accelerated filers (Monday, April 2, 2007 for December 31 year-end companies).

In addition, Form 10-Q reports filed by accelerated filers and large accelerated filers will continue to be due 40 days after the close of the fiscal quarter. The Form 10-Q due date for such filers will not be accelerated to 35 days as originally planned. The deadline for Form 10-Q reports for non-accelerated filers continues to be 45 days after the close of the fiscal quarter.

These changes do not affect the existing proxy statement filing deadline of 120 days after fiscal year-end for companies that choose to incorporate by reference from their definitive proxy statements the disclosure required by Part III of the Form 10-K.

The SEC has also made it significantly easier for companies that have had declines in the market value of their public float to exit accelerated filer status. An accelerated filer whose public float had dropped below $50 million as of the last business day of its second fiscal quarter may cease to report as an accelerated filer at the end of the fiscal year in which its public float fell below $50 million, and may therefore file its annual report for that year and subsequent periodic reports on a non-accelerated basis. The rules also contain similar requirements for exiting large accelerated filer status, permitting a large accelerated filer whose public float dropped below $500 million as of the last business day of its second fiscal quarter to cease reporting as a large accelerated filer as of the end of the fiscal year in which its public float fell below $500 million, and to file its annual report for that year and subsequent periodic reports as an accelerated filer, or a non-accelerated filer, as appropriate. Prior to these changes, companies that had become accelerated filers could only cease to report as accelerated filers if they became eligible to report as small business issuers.

Internal Control Over Financial Reporting

Companies that qualify as large accelerated filers and accelerated filers have now experienced two years of compliance with the requirements of Section 404 of Sarbanes-Oxley concerning internal control over financial reporting. As a reminder, those filers are required to include in their annual reports:

- an evaluation by management of the effectiveness of the company's internal control over financial reporting, and
- an attestation report from the company's independent accountants with respect to management's assessment of the company's internal control over financial reporting.

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[3] The proposed guidance is available at http://www.sec.gov/rules/proposed/2006/33-8762.pdf.

[4] The text of this press release is available at http://www.sec.gov/news/press/2006/2006-206.htm.

[5] Large accelerated filers are domestic companies that meet the following requirements as of their fiscal year-end:

- have a common equity public float of at least $700 million, measured as of the last business day of their most recently completed second fiscal quarter (*i.e.*, for calendar fiscal year-end companies, this test would be applied as of June 30, 2006);
- have been subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, for at least 12 months;
- have previously filed at least one Annual Report on Form 10-K; and
- do not qualify as small business issuers under SEC rules.

[6] *Accelerated filers* are those that meet all of the above tests but have a common equity public float of at least $75 million, but less than $700 million, measured as of the last business day of their most recently completed second fiscal quarter (*i.e.*, for calendar fiscal year-end companies, this test would be applied as of June 30, 2006).

Management must also evaluate any change in a company's internal control over financial reporting that occurs during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the company's internal control.

The SEC has provided some additional relief regarding internal control reporting for non-accelerated filers and newly public companies.[7] Non-accelerated filers had been scheduled to begin compliance with Section 404 reporting starting with fiscal years ending on or after July 15, 2007. In rule amendments adopted in December 2006, the SEC pushed back the compliance deadline for non-accelerated filers again, and now will require the management's report on internal control over financial reporting to be filed with the first annual report due on or after December 15, 2007, and the auditor's attestation report on internal control over financial reporting to be filed with the first annual report due on or after December 15, 2008. However, if a former non-accelerated filer becomes an accelerated filer during this extension period, the company would no longer be able to take advantage of this postponement, and the Section 404 reports would be required in the annual report that is filed for the fiscal year in which the company becomes an accelerated filer.

For companies that are newly public, the SEC has granted a transition period that will allow those companies not to have to include Section 404 reports in the first annual report that they file after becoming subject to the reporting requirements of the Exchange Act. This is a significant benefit for newly public companies that otherwise would have been required to prepare for Section 404 reporting immediately after going public. For our clients that are planning to go public in 2007, this revision will allow them to wait to include required Section 404 disclosures until their second annual report filed post-IPO.

Please note that if a company goes public early in a year (before February 15 for domestic issuers; before April 30 for foreign private issuers), using nine-month interim financial statements, that company's first annual report, in which the Section 404 reports will not be required, will be the one that is filed shortly after going public. The company would then become subject to Section 404 reporting in the next annual report, due the following year.

Management's annual report on internal control over financial reporting and the attestation report provided by your auditors, which are required pursuant to Item 308 of Regulation S-K, should appear either in close proximity to the Management's Discussion and Analysis section of the Form 10-K or immediately preceding the company's financial statements. In addition, the SEC has indicated that companies should include both management's report on internal control over financial reporting and the auditors' report on management's assessment of those controls in the annual report to shareholders when audited financial statements are included. The SEC has also noted that, if management states in the report that the company's internal controls are ineffective, or the auditors' report includes anything other than an unqualified opinion, and those reports are *not* included in the annual report to shareholders, the company would have to consider whether the failure to include those reports constitutes an omission of a material fact, rendering the annual report misleading.

If you receive any indication from your accountants that a qualified report will be issued, or that there are material weaknesses or significant deficiencies in your internal controls, you should consult with your counsel as soon as possible to determine any disclosure ramifications.

Compensation Disclosures— More Detail, More Scrutiny

In response to widespread demand from institutional and retail stockholder groups, on August 29, 2006 the SEC adopted new rules that require extensive additional detail on issuers' compensation practices, and require that this disclosure be presented in "plain English."[8] The rules were further amended, on December 29, 2006, to make certain revisions to the disclosure of the dollar amounts of stock awards and option awards required to be disclosed in the compensation tables.[9] A summary of the most significant aspects of the new executive compensation disclosure requirements is set forth below.

Changes to the Definition of "Named Executive Officer"

The new rules change the group of named executive officers (NEOs) for whom compensation information must be disclosed in the tables, as well as how those persons are determined.

7 Our Client Advisory regarding this relief is available on our website at http://www.mintz.com/newsletter/2006/Securities-Alert-Sarbanes404-12-06/

8 The final rules are available at http://www.sec.gov/rules/final/2006/33-8732a.pdf, and the amendments to the final rules are available at http://www.sec.gov/rules/final/2006/33-8765.pdf

9 Our Client Advisory regarding these amendments is available on our website at http://www.mintz.com/newsletter/2007/Securities-Alert-SEC-AmendExComp-01-07/

Previously, the rules required disclosure for the principal executive officer (PEO) and anyone who served as the PEO during the last completed fiscal year (regardless of salary), the *four* other most highly compensated executive officers who were serving at the end of the last completed fiscal year and who made more than $100,000, determined by reference to *only* their salary and bonus payments, and up to two additional individuals who would have been in the prior category but who were not serving as executive officers on the last day of the fiscal year.

Under the new rules, compensation information must be provided for the PEO and anyone who served as the PEO during the last completed fiscal year (regardless of salary), the principal *financial* officer (PFO) and anyone who served as the PFO during the last completed fiscal year (regardless of salary), the *three* other most highly compensated executive officers who were serving at the end of the last completed fiscal year and who made more than $100,000, and up to two additional individuals who would have been in the prior category but who were not serving as executive officers on the last day of the fiscal year. In addition, the $100,000 amount will now be determined by reference to total compensation earned by an officer as required to be disclosed in the Summary Compensation Table, reduced by any increases in the actuarial value of defined benefit plans and above market earnings on non-qualified defined contribution plans. The SEC is still considering whether to adopt the so-called "Katie Couric" rule, which would require disclosure in the Summary Compensation Table of highly-compensated individuals who are not executive officers of a company.

Compensation Discussion and Analysis

The new rules require most companies to provide a Compensation Discussion and Analysis section in their proxy statements or Form 10-Ks, discussing a company's philosophy on executive compensation for their NEOs.[10] Comparable to the Management's Discussion and Analysis of financial disclosure, or MD&A, the CD&A is viewed as the centerpiece of the principles-based reporting approach to executive compensation. John White, Director of the SEC's Division of Corporation Finance, said in a recent speech that "CD&A is what gives context to the required tables and the numbers in them….As [SEC] Chairman [Christopher] Cox explained at the Open Meeting at which the Commission adopted the new disclosure rules, CD&A 'will give companies an opportunity to explain their compensation policies, and to share with investors how they arrived at the particular levels and forms of compensation for their highest paid executives.'"[11]

The CD&A must discuss the six explicit items set forth below, and must also discuss and analyze other information which the directors considered in determining the amounts and types of compensation paid to the NEOs during the most recently completed fiscal year.

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How do each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?

Above all, the CD&A must not consist of boilerplate and it should not be a mere recitation of the process by which the directors determined compensation. The key is to analyze, in plain English, the elements of the company's executive compensation packages, explaining why decisions were made, by whom, and the interplay between the different elements of compensation and company and individual results. Director White notes that just as with MD&A, the analysis in the CD&A should "tell a compelling story…make that story relevant, qualitative and contextual, and avoid mere quantitative disclosure that just repeats the data" set forth in the compensation tables. The CD&A must also discuss the methods used to select terms of all equity awards, not just options, including the timing of awards and the policies regarding the determination of the exercise price of options, and how post-employment compensation arrangements, such as termination and change-in-control payments, were determined as they apply to current compensation arrangements.

Unlike the former Compensation Committee Report, the CD&A is considered a company disclosure, rather than a report of a committee of the board of directors. It will be considered "filed" and not "furnished" under the securities laws. This means both that a company will be liable for any material misstatements contained in the CD&A and that a company's principal executive and principal financial officers are required to certify the information contained in the CD&A as part of their Sarbanes-Oxley Act certifications filed as exhibits to the Form 10-K. For companies planning to incorporate into the Form 10-K their compensation disclosures from their proxy statements, as is common, the CD&A disclosure

[10] The CD&A is not required for small business issuers and foreign private issuers.

[11] Mr. White's speech is available at http://www.sec.gov/news/speech/2006/spch090606jww.htm

should be completed or near completion prior to the filing of the Form 10-K.

Compensation Committee Report

In addition to the CD&A, the compensation committee or other board committee performing equivalent functions must furnish a report, similar to the Audit Committee Report that is currently required in proxy statements, as to whether it has reviewed and discussed the CD&A with management, and based on this review and discussion whether the compensation committee recommended to the Board of Directors that the CD&A be included in the company's Form 10-K and proxy statement. Unlike the Audit Committee Report, however, this Compensation Committee Report will be furnished in the proxy statement and not filed or incorporated by reference into the Form 10-K and therefore will not be covered by the company's officer certifications. This Compensation Committee Report may, however, be relied upon by the company's officers when providing their certifications.

Changes to Compensation Tables

Issuers are required to provide executive compensation disclosure in three broad categories: compensation earned during the most recently completed fiscal years; holdings of outstanding equity-related interests received as compensation that may be the source of future gains; and retirement plans and other post-employment payments and benefits. As a means of transitioning into the new disclosures, for the 2006 fiscal year, compensation data in the tables is only required for one year. In the 2007 fiscal year, compensation data will be required for two fiscal years (2007 and 2006), and in the 2008 fiscal year and beyond, compensation data will be required for three fiscal years.

The Summary Compensation Table has been reorganized, and a new column in this table reports "total compensation" paid to the company's NEOs. This new concept is intended to capture a total dollar value including salary, bonus, equity grants, cash incentive awards, and all perquisites exceeding $10,000 in the aggregate.

A new supplemental table, entitled "Grants of Plan-Based Awards," requires disclosure on an award-by-award basis of all equity and non-equity estimated future payouts under performance-based awards and amounts payable under other equity awards that are not performance-based. A new "Outstanding Equity Awards at Fiscal Year-End" table shows each outstanding stock option held by each NEO as of the end of the fiscal year on a grant-by-grant basis, and a new "Option Exercises and Stock Vested" table reports options exercised and vesting of restricted stock, restricted stock units and similar instruments, including an aggregate dollar value realized upon the vesting or the transfer of an award for value (*e.g.,* a sale).

New retirement plan and post-employment disclosure includes:

- a "Pension Benefits" table, which discloses the present value of any accumulated pension benefit, change in present value of any accumulated benefit in last fiscal year and any payments made during the last fiscal year;
- a "Nonqualified Deferred Compensation" table, which would set forth contributions made by either the company or the NEO, aggregate earnings under, aggregate distributions or withdrawals from and the aggregate balance as of the last day of a company's fiscal year; and
- disclosure of the dollar amounts that could be due to each of the NEOs in the event of various termination or change in control scenarios. This disclosure should be presented in a table to enhance readability, followed by a narrative explanation of any material facets of the arrangements. The table should present all possible payment and compensation scenarios for each of the NEOs in the event that their employment is terminated as a result of a change in control, retirement, a voluntary termination of employment, a termination for cause, a termination without cause, death or disability and all other permutations of severance set forth in the applicable NEO employment package. The information must be set forth assuming that the triggering event resulting in the payment occurred on the last day of a company's fiscal year, using the company's stock price as of the same date.

Please contact the Mintz Levin attorney with whom you work if you have any questions on how to treat elements of compensation under these new disclosure requirements.

Director Compensation

Companies now must include a separate table disclosing all compensation paid to their directors during the past fiscal year. Please note that the table must address compensation for *anyone* who served as a director at any time during the fiscal year, even if that person was not serving as a director at the end of the fiscal year. The table, which is similar to the revised Summary Compensation Table required for NEOs, will include all compensation paid for services as a director, including retainer fees, committee and/or chairmanship fees, meeting fees, the total dollar amount recognized from all equity and equity-based awards outstanding for financial

statement reporting purposes for the applicable fiscal year calculated in accordance with SFAS 123(R), disregarding any estimates allowed for financial statement reporting purposes of forfeitures by directors, all perquisites and other personal benefits, unless the aggregate amount of such benefits does not exceed $10,000, changes in pension values, above market earnings on nonqualified deferred compensation and all other types of compensation. A narrative description of any material factors necessary to an understanding of the table must follow the table, including a description of the standard compensation arrangements for the directors, and whether any director has a compensation arrangement that differs from the standard arrangement.

Perquisites

Under the new rules, the threshold for disclosing perquisites as part of the compensation disclosed in the Summary Compensation Table has been reduced to $10,000 per year. Each perquisite is required to be identified in a footnote to the Summary Compensation Table, and each perquisite that exceeds the greater of $25,000 or 10% of the total of all perquisites paid to an NEO must be quantified.

In the adopting release for the new rules, the SEC provided some guidance as to what should be considered to be a perquisite, as follows:

> Among the factors to be considered in determining whether an item is a perquisite or other personal benefit are the following:
>
> - An item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties.
> - Otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees.
>
> We believe the way to approach this is by initially evaluating the first prong of the analysis. If an item is integrally and directly related to the performance of the executive's duties, that is the end of the analysis – the item is not a perquisite or personal benefit and no compensation disclosure is required. Moreover, if an item is integrally and directly related to the performance of an executive's duties under this analysis, there is no requirement to disclose any incremental cost over a less expensive alternative. For example, with respect to business travel, it is not necessary to disclose the cost differential between renting a mid-sized car over a compact car.
>
> Because of the integral and direct connection to job performance, the elements of the second part of the analysis (*e.g.*, whether there is also a personal benefit or whether the item is generally available to other employees) are irrelevant. An example of such an item could be a "Blackberry" or a laptop computer if the company believes it is an integral part of the executive's duties to be accessible by e-mail to the executive's colleagues and clients when out of the office. Just as these devices represent advances over earlier technology (such as voicemail), we expect that as new technology facilitates the extent to which work is conducted outside the office, additional devices may be developed that will fall into this category.
>
> The concept of a benefit that is "integrally and directly related" to job performance is a narrow one. The analysis draws a critical distinction between an item that a company provides because the executive needs it to do the job, making it integrally and directly related to the performance of duties, and an item provided for some other reason, even where that other reason can involve both company benefit and personal benefit.
>
> Some commenters objected that "integrally and directly related" is too narrow a standard, suggesting that other business reasons for providing an item should not be disregarded in determining whether an item is a perquisite. We do not adopt this suggested approach. As we stated in the Proposing Release, the fact that the company has determined that an expense is an "ordinary" or "necessary" business expense for tax or other purposes or that an expense is for the benefit or convenience of the company is not responsive to the inquiry as to whether the expense provides a perquisite or other personal benefit for disclosure purposes. Whether the company should pay for an expense or it is deductible for tax purposes relate principally to questions of state law regarding use of corporate assets and of tax law; our disclosure requirements are triggered by different and broader concepts.

The SEC also reiterated that aggregate incremental cost is the proper measure of value of perquisites and that the amount attributed to such benefits for federal income tax purposes is not generally deemed the incremental cost.

In the adopting release for the new rules, the SEC provided the following non-exclusive list of items that it considers to be perquisites:

- club memberships not used exclusively for business entertainment purposes,
- personal financial or tax advice,
- personal travel using vehicles owned or leased by the company,
- personal travel otherwise financed by the company,
- personal use of other property owned or leased by the company,
- housing and other living expenses (including but not limited to relocation assistance and payments for the executive or director to stay at his or her personal residence),
- security provided at a personal residence or during personal travel,
- commuting expenses (whether or not for the company's convenience or benefit), and
- discounts on the company's products or services not generally available to employees on a non-discriminatory basis.

Related Person (Not Party) Transactions

The new rules update, clarify and somewhat expand existing disclosure requirements for related person transactions. The SEC views related party disclosure—now called "related person" disclosure—as critical to investors in evaluating executive compensation and director independence. As with executive compensation, the SEC has emphasized that the new rules for related person disclosure focus on principles, rather than bright-line rules, and the SEC has accordingly eliminated some of the instructions and specific exceptions that previously permitted issuers to exclude disclosure. Generally, revised Item 404 of Regulation S-K:

- focuses on a materiality analysis, based on principles rather than explicit rules and exceptions;
- increases the *de minimis* dollar threshold for disclosure from $60,000 to $120,000, such that transactions below that amount need not be evaluated for materiality;
- eliminates separate disclosure under Item 404(b) and (c) for certain director relationships and indebtedness, bringing this disclosure under the materiality analysis of Item 404(a);
- expands the definitions of "transaction," "related person," and "immediate family member;" and
- requires disclosure of companies' policies and procedures for the review, approval or ratification of related person transactions.

New Item 404(a) requires the disclosure of any "transaction" (including indebtedness, which was previously covered under Item 404(c)), 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";
- if the amount involved exceeds $120,000; and
- any "related person" has or will have a direct or indirect material interest.

Materiality determinations are to continue to be made on the basis of the significance of the information to investors in light of all the circumstances, even though the SEC has eliminated its former instruction to this effect. Also, once it is determined that disclosure is required, the *content* of the disclosure remains largely unchanged, except that the new rule adds a "catch all" provision requiring disclosure of any other information that is material to investors in light of the circumstances.[12]

As the definition of a non-employee director for purposes of the exemption from liability for transactions between an issuer and its officers and directors under Section 16 of the Securities Exchange Act of 1934, as amended, is determined based on the director not having any disclosure under Item 404(a) of Regulation S-K, companies should review the makeup of their compensation committees to determine whether all of their compensation committee members continue to meet the Section 16 definition of non-employee director in light of these changes to Item 404.

Beneficial Ownership Table—Disclosure of Pledges Required

As part of the release on the new compensation disclosures, the SEC has revised the table requiring inclusion of beneficial ownership information, as set forth in Item 403(b) of Regulation S-K, to require footnote disclosure to the table of any securities of the registrant that have been pledged as security for an obligation by NEOs, directors and director nominees of shares held by those persons. We have added a question to our form of director and officer questionnaire that is designed to elicit this information, although pledges of shares by company insiders are frequently prohibited by insider trading policies.

Performance Graph: Now Required Only in "Glossy" Annual Report

The SEC has also moved the location of the stock performance graph. Previously, this table was required to be included in a company's proxy statement for its annual stockholders' meeting under prior Item 402(l) of Regulation S-K. Under the new rules, the

[12] For a further explanation of these changes, please see our Client Advisory on the new executive compensation disclosure rules, available at http://www.mintz.com/publications/detail/520/Securities_Law_Advisory_The_SECs_Compensation_Disclosure_Reforms_PrinciplesBased_Disclosure_Arrives_for_Executive_Compensation/.

requirement to provide a stock performance graph has been moved to Item 201(e) of Regulation S-K, and is required only in the annual report required by Rule 14a-3 under the Exchange Act, which is the annual report to stockholders that must accompany or precede a proxy statement for the annual meeting of stockholders. As under the prior rules, the performance graph will be furnished and not filed, and is not required to be provided by small business issuers.

Corporate Governance Disclosure and Committee Charters

As a part of the changes brought about by the new executive compensation disclosure rules, the SEC has consolidated its disclosure requirements on corporate governance issues, such as the identity and independence of the various committees of the board of directors, into new Item 407 of Regulation S-K. Examples of the disclosure that is required include:

- whether each director and director nominee is independent;
- a description of any relationships not otherwise disclosed that were considered when determining whether each director and director nominee is independent; and
- disclosure of any audit, nominating and compensation committee members who are not independent.

The SEC has also added to the disclosure that is required information concerning the activities of the compensation committee of the board. For the first time, issuers are required to include disclosure on the following topics with respect to the compensation committee:

- the scope of authority of the compensation committee;
- the extent to which the compensation committee may delegate any authority to other persons (such as the delegation of authority to the principal executive officer to grant stock options), specifying what authority may be so delegated and to whom; and
- the role, if any, of executive officers in determining or recommending the amount or form of executive and director compensation.

In addition, issuers are required to state whether or not their compensation committees operate under a written charter and if so, whether a current copy of the charter is available to securityholders on the issuer's Internet site. The SEC has also provided that an issuer may satisfy its disclosure requirement for the charters of the nominating and audit committees of the board by posting these charters on its website, rather than including copies as appendices to the issuer's proxy statement once every three years. As a result, we recommend that issuers post all three charters on a Corporate Governance section of their websites, in order to ensure that the public availability requirement is satisfied. If your company's compensation committee does not currently have a charter, please contact us to obtain a sample form.

Impact of Section 409A of the Internal Revenue Code

As you are aware, the United States Congress enacted Section 409A of the Internal Revenue Code in October 2004 and directed the Internal Revenue Service and the Treasury Department to draft regulations providing much of the detail under that section. On September 29, 2005, the IRS issued proposed regulations regarding Section 409A which companies may rely on until final rules are enacted.[13] Section 409A broadly regulates "deferred compensation," which is defined to include stock options. Among other things, Section 409A applies to stock options that are granted below fair market value and potentially also to any stock option that is later modified.

If an option, as initially granted or *as subsequently modified,* is deemed under Section 409A of the Code to be deferred compensation and the option does NOT meet the strict requirements of Section 409A, the optionee will initially be subject to income tax in the year of vesting rather than the date of exercise (or later). The tax will be based on the spread between the exercise price of the option and the fair market value of the underlying stock on the last day of the year in which the portion of the option vested, plus an additional excise tax of 20% as a penalty for non-compliance with Section 409A and, potentially, interest from the date compensation is deemed to have been deferred. Some of these taxes are required to be withheld by the employer and paid to the IRS in connection with regular withholding payments. The penalty tax must be paid by the employee. If the payments to the IRS are not made in a timely fashion, the company issuing the option could be subject to penalties for late withholding.

Although it is customary for public companies to grant stock options at fair market value, it is important to be aware of the new regulations as Section 409A must be analyzed whenever options are modified or assumed in a merger transaction. In addition to stock options, Section 409A applies to any compensation to which the company has provided the recipient a legally binding right to be paid (even if such right is conditional), and the right to the com-

[13] Our Client Advisory regarding the effect of Section 409A on stock options and other types of equity grants is available on our website at http://www.mintz.com/newsletter/BF-409A-Alert-1205/index.htm. As of the date of this Memorandum, the final rules have still not been issued.

pensation is “earned and vested.” An amount is not “earned and vested” if it is subject to a substantial risk of forfeiture. In addition to traditional deferred compensation plans, Section 409A can apply to, among other things, bonus arrangements and severance payments if the time of payment does not comply with the new stringent requirements imposed by Section 409A. If you have not done so already, now is the time to analyze all of the arrangements that your company has in place, as much of the noncompliance can be rectified if modifications to these arrangements to comply with Section 409A are made prior to January 1, 2008.

Continuing Focus on Management’s Discussion and Analysis

The SEC continues its focus on improvements to the MD&A disclosure in companies’ periodic reports, and has emphasized in comment letters and public statements that it expects companies to emphasize the “A”—for Analysis—in their MD&A sections, rather than simply presenting financial statement numbers and comparisons to results from prior periods. On December 19, 2003, the SEC issued a seminal document containing guidance with respect to overall MD&A disclosure, which is still relevant and pertinent to preparation of MD&A. In that document, the SEC noted that the three principal objectives of MD&A are as follows:

- to provide a narrative *explanation* of a company’s financial statements that enables investors to see the company through the eyes of management;
- to enhance the overall financial disclosure and provide the *context* within which financial information should be analyzed; and
- to provide information about the quality of, and potential variability of, a company’s earnings and cash flow, so that investors can *ascertain the likelihood that past performance is indicative of future performance.*[14]

We strongly recommend that each member of your disclosure committee and each person responsible for the preparation of MD&A read (or re-read) the SEC’s December 2003 release as part of the drafting process for this year. The SEC notes in the December 2003 release its belief that the MD&A is a “critical component” of companies’ communications with their investors. As such, the MD&A should contain a thoughtful presentation and analysis, through company management’s eyes, of the changes in the company’s financial picture during the reporting period, the trends and uncertainties that may cause that picture to vary over the coming months, and the impact of future trends on the company’s access to, and availability of, cash resources. Do not shy away from a look into the future. Indeed, the MD&A requires disclosure of the reasonably expected impacts of known events and uncertainties. Other forward-looking disclosures are encouraged, and if identified as such and qualified with adequate risk factors and cautionary statements, will be protected under Section 21E of the Exchange Act.

The following are additional tips in preparing MD&A, as outlined by the SEC in its release:

- Present the most important information in the most prominent manner and eliminate immaterial information.
- Avoid unnecessary duplication of disclosure that appears elsewhere in the document. Points do not have to be made two, three or four times for emphasis.
- Consider starting the MD&A with an overview of material points, creating context for the rest of the discussion. The overview should change over time, not remain static.
- Analyze the data—do not merely summarize the financial statements.
- Pay particular attention to the liquidity section—are all sources and uses of cash and cash requirements adequately described and analyzed? Consider tabular presentations of relevant financial data.
- Where the company has made material accounting estimates or assumptions in the preparation of its financial statements, describe them in the MD&A. This disclosure should not merely duplicate the description of accounting policies that appears in the notes to the company’s financial statements.

In addition, as we have noted previously, companies should expect increased scrutiny of their annual and quarterly reports going forward, because Section 408 of Sarbanes-Oxley requires the SEC to review every registrant’s periodic reports at least once every three years.[15] The SEC is more frequently issuing comments on only one or two aspects of a registrant’s filings, and the MD&A and financial statements are common target areas for these comments. If the SEC finds, as part of that review, that a company has not followed these

[14] The December 2003 MD&A release can be found at http://www.sec.gov/rules/interp/33-8350.htm.

[15] Please see our Client Advisories dated (i) June 10, 2002 (“SEC Proposes New MD&A Disclosure Regarding Critical Accounting Estimates and Initial Adoption of Accounting Policies”) and (ii) January 27, 2003 (“Update on the Sarbanes-Oxley Act (Eighth in a Series): SEC Adopts Final Rules Under Additional Provisions of Sarbanes-Oxley”), available at http://www.mintz.com/newspubs/Bus-Fin&Sec/SecAdvisory0602.pdf, for a further discussion of this topic.

guidelines in the preparation of its MD&A, the SEC will issue a comment requiring changes to be made in the disclosure to address the guidelines. Please note that all SEC comment and response letters on filings are now being made publicly available, on the SEC web site, following the completion of a review, and as a result such correspondence is readily accessible by your securityholders and competitors.

Board of Director and Committee Membership

Each year as part of the year-end reporting process, we recommend that companies carefully examine the membership profiles of their board and board committees. Sarbanes-Oxley, the SEC rules issued under Sarbanes-Oxley, and changes to the listing requirements of Nasdaq, NYSE and AMEX relating to board and committee membership requirements have all made an impact on who may serve.[16] Mintz Levin has prepared a director independence and qualification checklist to assist with this analysis, and we encourage you to evaluate each director and director nominee to ensure continued compliance with these requirements.

Director Independence

Nasdaq's, NYSE's and AMEX's rules (i) require each listed company to have a majority of independent directors serving on its board and (ii) define who qualifies as an independent director. Mintz Levin's form of *Director and Officer Questionnaire* includes questions designed to help companies determine whether a particular director will qualify as independent under the listing requirements. Nasdaq has proposed an amendment to its listing requirements that would raise the dollar threshold for determining whether a transaction with a director will cause the director to fail to satisfy the independence requirements from $60,000 during any period of twelve consecutive months to $120,000 during such period, in order to conform to the SEC's new threshold under Item 404(a) of Regulation S-K, as described above.

In addition, Nasdaq, NYSE and AMEX require companies to disclose which directors have been affirmatively determined by the board of directors to have no relationship with the company that would interfere with the exercise of independent judgment in carrying out their responsibilities as a director.

Audit Committee Membership

In addition to the independence requirements imposed by Nasdaq, NYSE and AMEX for members of the board of directors, members of the audit committee are required to have greater knowledge of accounting matters and comply with even stricter independence standards. Rule 10A-3 under the Exchange Act provides that audit committee members may not be considered independent if they (i) directly or indirectly accept *any* consulting, advisory or other compensatory fee from the issuer other than in their capacity as a member of the board or a committee thereof or (ii) are affiliated persons of the issuer or any subsidiary. In addition, no audit committee member may have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years. Each audit committee member must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement at the commencement of the audit committee member's term instead of within a reasonable time thereafter, as was previously permitted. In addition, any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer's audit committee.

In response to the directive of Rule 10A-3, Nasdaq, NYSE and AMEX prohibit the listing of any security of an issuer if each member of its audit committee is not independent under Rule 10A-3, subject to certain limited exceptions.

Compensation Committee Membership

Under Nasdaq, NYSE and AMEX corporate governance requirements, compensation of the CEO and all other executive officers must be determined, or recommended to the board for determination, either by a majority of the independent directors, or by a compensation committee that is comprised solely of independent directors. In addition, the chief executive officer may not be present at the deliberations of, or voting by, the compensation committee with respect to his or her own compensation.

Additional considerations affect the composition of a public company's compensation committee in connection with other statutory and regulatory requirements. In order for a public company to derive a federal tax deduction for performance-related compensation expenses which result in more than $1 million of compensation being earned by an executive officer subject to Section 162(m), including the recognized gain arising from stock option grants, the company's compensation committee which authorized the compensation must be comprised entirely of "outside directors," as defined in Section 162(m). In addition, Rule 16b-3 under the Exchange Act provides that one way of exempting stock option grants from the short-swing trading restrictions of Section 16(b) of the

[16] Please see our Client Advisory, dated November 2003, entitled "Changes to Corporate Governance Standards for Nasdaq-Listed Companies," for a further description of these changes.

Exchange Act is to have stock option grants approved by a compensation committee that is comprised solely of at least two "non-employee directors," as defined in Rule 16b-3. We recommend that public companies make every effort to have all members of their compensation committees qualify as "outside directors" for purposes of Section 162(m) and "non-employee directors" for purposes of Rule 16b-3.

Nominating Committee Membership

The listing standards of Nasdaq, the NYSE and the AMEX provide that the nomination of directors must be determined either by a majority of independent directors or by a separately constituted committee. These listing standards do not require listed companies to consider shareholder nominees, although issuers must certify that they have adopted either a formal written charter or board resolutions addressing the nominations process. Nominating committees must also nominate the candidates for election at the company's annual meeting of shareholders, and those nominations must be accepted by the company's full board of directors.

Electronic Delivery of Proxy Materials

The SEC has finalized its "e-proxy" rules, which will allow (but not require) public companies to satisfy the requirement to deliver proxy materials for each annual meeting to stockholders by making the required documents available electronically.[17] These rules will require issuers who choose to rely on electronic delivery to post their proxy materials on a publicly accessible website (not including www.sec.gov, but an issuer's own website would qualify). The posted proxy materials must be substantially identical to any printed version of the proxy materials. Issuers would be required to send to stockholders, in paper form, a "Notice of Internet Availability of Proxy Materials" (a "Notice") at least 40 calendar days prior to the date of the shareholder meeting, alerting investors as to the date, time and place of the meeting, the address of the website where the proxy materials are posted; contact information that shareholders may use to get paper versions of the proxy materials; and a description of matters to be acted on at the meeting. An issuer may not send a proxy card along with the Notice, but it may send the proxy card ten or more calendar days after sending the Notice, provided that a copy of the Notice accompanies the proxy card.

Issuers will also still be required to file the proxy materials with the SEC via EDGAR. Financial intermediaries, such as banks and brokerage firms, would be required to prepare their own Notices to send to their beneficial shareholders, which will direct the owner to request paper or e-mail copies of the soliciting material from the intermediary, rather than from the issuer. Issuers may not rely on the new rules to send out Notices until July 1, 2007, which means that meetings held using proxy materials distributed using the electronic delivery model may not occur before August 10, 2007.

If a stockholder requests a paper copy of the documents, the issuer would be required to respond to the stockholder's request within two business days and provide the documents in paper form, at no charge to the stockholder.

The SEC has indicated that these amendments have no impact on any state law obligations regarding soliciting proxies or holding annual meetings, and electronic delivery may not be used for proxy statements regarding business combination transactions.

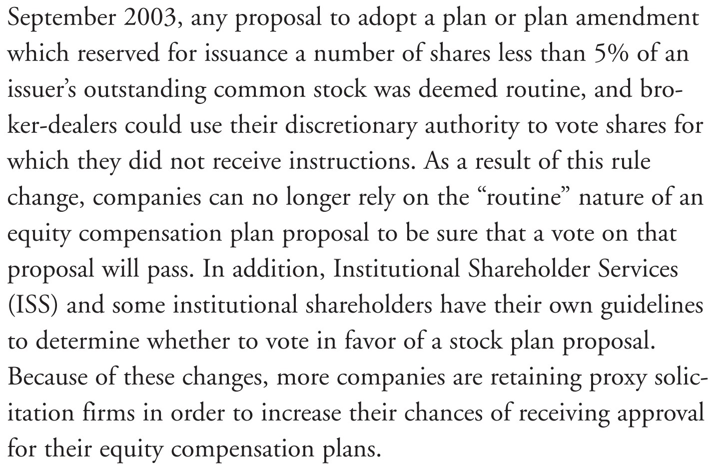
Stockholder Approval of Equity Compensation Plans

Nasdaq, AMEX and NYSE all require shareholder approval for the adoption of equity compensation plans and arrangements for employees, directors and consultants and for any material modification of such plans and arrangements, including the addition of new shares to a plan. Exemptions from the stockholder approval requirement continue to be available for inducement grants to new employees if such grants were approved by a compensation committee or a majority of the company's independent directors and promptly following the grant a press release is issued specifying the material terms of the award, including the name of the recipient and the number of shares issued, and in certain situations relating to an acquisition or merger. An exemption from the stockholder approval requirement is also available for certain tax-qualified, non-discriminatory employee benefit plans (such as plans that meet the requirements of Section 401(a) of the Internal Revenue Code), provided that such plans are approved by the issuer's compensation committee or a majority of the issuer's independent directors. Equity plans adopted prior to June 30, 2003 are unaffected under this rule, until a material modification is made to such a plan.

Companies should review their existing equity compensation plans as part of their year-end reporting preparation in order to determine whether shareholder approval will need to be obtained for new plans, increases in the numbers of shares available under old plans, or other material plan amendments.

Another revised rule now affects votes taken at shareholder meetings with respect to equity compensation plans. Registered broker-dealers holding stock in "street name" may no longer use their discretionary voting power to vote on any stock plan proposals without explicit instructions from the beneficial owner. Prior to

[17] These rules are available at http://www.sec.gov/rules/final/2007/34-55146.pdf.



September 2003, any proposal to adopt a plan or plan amendment which reserved for issuance a number of shares less than 5% of an issuer's outstanding common stock was deemed routine, and broker-dealers could use their discretionary authority to vote shares for which they did not receive instructions. As a result of this rule change, companies can no longer rely on the "routine" nature of an equity compensation plan proposal to be sure that a vote on that proposal will pass. In addition, Institutional Shareholder Services (ISS) and some institutional shareholders have their own guidelines to determine whether to vote in favor of a stock plan proposal. Because of these changes, more companies are retaining proxy solicitation firms in order to increase their chances of receiving approval for their equity compensation plans.

Other Year-End Considerations

We also recommend that companies take the opportunity while planning their year-end reporting to consider what amendments may be necessary or desirable to their corporate documents over the coming year that may require stockholder approval. Some items to consider are:

- Does the company have enough shares authorized under its certificate of incorporation to achieve all of its objectives for the year, including acquisitions for which it may want to use its stock as currency?
- Does the company have adequate shares available under its equity compensation plans to last throughout the year?
- Are there other material changes that should be made to the company's equity compensation plans that would require shareholder approval?
- Has the company reviewed its charter and by-laws to assess any anti-takeover measures in place?
- Have the committees of the board of directors reviewed and updated their charters to reflect the new requirements relating to those committees?

To the extent that a company expects any proposal in its proxy statement to create controversy among its stockholder base, it may want to consider hiring a proxy solicitor to assist with the process of seeking the requisite stockholder vote.

Mintz Levin Website: Client Publications

We would also like to call your attention to the many client advisories and alerts regarding topics of current interest that are available to you through the Corporate Governance Gateway on our website, **www.mintz.com**. New alerts and advisories are posted periodically, and we hope that you will find the information to be useful.

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