COMPLIANCE 2007: EXECUTIVE COMPENSATION TIPS FOR SMALL AND MID-CAP PUBLIC COMPANIES

As we head into the 2007 proxy season, public companies will contend with the new disclosure rules and regulations adopted by the Securities and Exchange Commission. These regulations affect the disclosure of compensation paid to executive officers and directors during the prior fiscal year. Combined with the recent stock option backdating scandal, investor and regulatory scrutiny of executive compensation policies will be closer than ever in 2007.

While large public companies have the financial wherewithal to employ teams of accountants, lawyers and other consultants to analyze disclosure issues and prepare reports, small and mid-cap companies must contend with the new regulations and scrutiny with fewer resources. The following contains some tips for handling executive compensation, and the disclosure of such compensation, in 2007.

<u>Set up a Compensation Committee</u>. Many smaller public companies do not have a separate compensation committee to set compensation policies and determine individual packages. In the absence of such a committee, compensation decisions rest with the entire board of directors. Every public company should have a separate compensation committee, populated with individuals with some experience in the compensation arena. Good candidates for a compensation committee include CPAs, attorneys, and compensation or human resource consultants.

<u>Create Compensation Guidelines in Advance</u>. Many smaller public companies engage in ad hoc compensation – they determine a compensation package or reward in a vacuum. Often the package or reward then sets the tone for future compensation, such as when a subsequent hire must receive a package that is at least as lucrative as that offered to an initial hire, even when the two hires have different experience or performance goals. A public company's compensation committee should create an overall compensation strategy that includes consideration of different types of compensation (salary, bonus, options, stock grants, etc.) and a set of ranges for officers with similar duties and responsibilities. In addition, the compensation committee should obtain and consider salary surveys in appropriate industries and comparable companies.

<u>Review all Outstanding Compensation Packages, Including Salaries, Bonuses, Securities Awards and Perquisites</u>. In addition to creating a compensation policy for future packages and awards, the compensation committee should review all current compensation packages. Beginning in 2007, detailed disclosure of these packages and awards is required, and information will need to be updated as awards vest and other compensation arrangements change.

Have a System for Tracking Compensation Awards, Including Vesting and Expiration. Given the funding constraints that smaller public companies experience, tracking of compensation awards often is accomplished manually. This can lead to information gaps that will carry over to public reports, such as principal stockholder tables that fail to account for options and other awards that will vest within the next 60 days or awards that have expired. The new SEC executive compensation regulations will require public companies to disclose all compensation that has vested in a given fiscal year, so accurate tracking will be critical. Software that handles this tracking is currently available, and vendors continue to develop lower cost packages meeting the requirements of smaller public companies.

Don't Forget the Perquisites. New rules govern the disclosure of perquisites and personal benefits, beginning in 2007, if the aggregate value of such perquisites and personal benefits exceed $10,000 in the aggregate. The SEC has attempted to clarify what items of compensation constitute a perquisite or a personal benefit by focusing first on excluding certain items – 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, the 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 a business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees. The examples cited by the SEC indicate a very narrow interpretation of "integrally and directly related"; when in doubt, disclosure of the item should be evaluated keeping in mind this narrow view. Public companies, through their compensation committees, need to keep track of all benefits awarded to executive officers during the year.

Begin Preparation of Annual Reports and Proxy Statements Early in 2007. With all of the new disclosure requirements, it will be important to allow extra time for compensation and audit committee review of the Form 10-K (or Form 10-KSB) and proxy statement well in advance of filing deadlines. In addition, accounting departments will undoubtedly require additional time to gather information for the new executive and director compensation tables and footnotes. Given their usual infrastructure challenges, small and mid cap public companies should begin to coordinate the collection of information and preparation of disclosures as soon as possible after the end of the fiscal year.

With advance preparation, the 2007 annual report and proxy season need not be as much of a challenge as indicated by the voluminous new executive compensation disclosure regulations approved by the SEC. Companies can rely on experienced SEC counsel and accountants to provide guidance in planning for and moving through the disclosure process.