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SEC Adopts New Disclosure Requirements Regarding Executive Compensation and Corporate Governance Matters

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On December 16, 2009, by a 4-to-1 vote, the Securities and Exchange Commission (the "SEC") adopted amendments to the disclosure requirements regarding executive compensation and corporate governance matters originally proposed on July 10, 2009. The SEC believes that these newly adopted disclosure requirements for annual reports and proxy and information statements will enable shareholders to better evaluate the leadership of public companies and will enhance their ability to make informed voting and investment decisions.

The amendments include required disclosures relating to: (i) compensation policies and practices that present material risks to the company; (ii) director and nominee qualifications; (iii) a company's leadership structure and the board's role in risk oversight; and (iv) potential conflicts of interest of compensation consultants who advise companies. In addition, the final rules provide for accelerated reporting of shareholder voting results on Form 8-K and revise the disclosure of stock and option awards in the Summary Compensation Table and Director Compensation Table. The final rules reflect important changes to the original proposals following the SEC's review of comments on the rules as originally proposed. The effective date for the final rules is February 28, 2010, except that the stock and option award changes are effective for companies providing disclosure for fiscal years ending on or after December 20, 2009.

Enhanced Disclosure of Company Compensation Policies and Practices as they Relate to Risk Management

Under the amendments, a company is required to disclose its compensation policies and practices for all employees, including non-executive officers, if such compensation policies and practices create risks that are reasonably likely to a have a material adverse effect on the company. These new disclosures focus on how the incentives in a company's compensation policies and practices create risk for the company and how the company manages that risk. The SEC believes that these types of disclosures help investors identify whether the company has established a system of incentives that can lead to inappropriate or excessive risk-taking by employees. The new disclosure requirements will not apply to smaller reporting companies.

Disclosure is only required to the extent that the risks are "reasonably likely to a have a material adverse effect on the company." In response to concerns expressed by certain commenters on the proposed rules, the SEC raised the threshold of required disclosure from risks that "*may* have a material effect on the company" (emphasis added) under the original proposal to risks that are "*reasonable likely* to have a material *adverse* effect on the company" (emphasis added). This higher threshold, the SEC argues, should elicit only those disclosures that are most relevant to investors and may encourage companies to examine and improve incentive structures for management and employees.

Because these new disclosures extend beyond the named executive officers ("NEOs") and include disclosure of broader compensation policies and practices for employees, the new disclosure concerning material risk is required to be discussed in a separate paragraph under new Item 402(s) of Regulation S-K instead of in the Compensation Discussion and Analysis as originally proposed. While this disclosure generally will depend on the particular facts and circumstances, the SEC provided a non-exclusive list of compensation programs that may create material risks to a company. This list includes compensation policies and practices:

- at a business unit of a company that carries a significant portion of the company's risk profile;
- at a business unit with compensation structured significantly differently than other units within the company;
- at a business unit that is significantly more profitable than others within the company;

- at a business unit where the compensation expense is a significant percentage of the unit's revenues; and
- that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

The SEC indicated that there may be other features of a company's compensation policies and practices that have the potential to incentivize employees to create risks that are reasonably likely to have a material adverse effect on the company.

If risk disclosure is required, the company must provide narrative disclosure of its policies and practices of compensation as they relate to risk management practices and risk-taking incentives. Some examples (which are non-exclusive as well) that should be discussed include:

- the general design philosophy of the company's compensation policies for employees whose behavior would be most affected by the incentives established by the policies, as such policies relate to or affect risk-taking by those employees on behalf of the company, and the manner of their implementation;
- the company's risk assessment or incentive considerations, if any, in structuring its compensation policies or in awarding and paying compensation;
- how the company's compensation policies relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods;
- the company's policies regarding adjustments to its compensation policies to address changes in its risk profile;
- material adjustments the company has made to its compensation policies or practices as a result of changes in its risk profile; and
- the extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

Finally, the amendments do not require a company to make an affirmative statement that risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company if it concluded that disclosure was not required.

Enhanced Director and Nominee Disclosure

The new SEC disclosure requirements are designed to present a fuller portrait to investors of the characteristics and experience of individual incumbent directors and nominees. Given what the SEC referred to in its proposing release as “recent market events” and the importance of directors’ capacity to assess risk and respond to complex financial and operational challenges, the new disclosure obligations are intended to give public investors a broader “character study” of directors (what the SEC refers to as their “competence and integrity”), and as a result of an extension of the look-back period for litigation disclosure and a broadening of the categories of litigation matters to be disclosed, the amendments provide investors more information by which they could determine the suitability of a director or nominee.

- The amendments require that registrants “briefly discuss” the “specific experience, qualifications, attributes or skills” of the individuals in “light of the registrant’s business and structure” that “lead to the conclusion that the person should serve as a director.” This approach represents a compromise from the initial SEC proposal that sought disclosure of skills or attributes that “qualified” the person to be a director, and that also sought disclosure of “risk assessment skills.” The SEC has indicated that this final language should focus disclosure on the “reasons for the decision that the person should serve as a director.”
- The SEC retained the current provisions of S-K Item 407(c)(2)(v), which requires disclosure of specific minimum qualifications that a registrant’s nominating committee believes must be met, and any specific qualities or skills they believe are necessary for the directors to possess.
- The enhanced legal proceedings disclosure requires information regarding directors’ and nominees’ involvement in certain legal proceedings over a ten-year period (rather than a five-year period under the prior rule). In addition, the triggers for disclosure have expanded along the legal spectrum beyond convictions, injunctions or civil violations of the securities laws—they now include orders, judgments, decrees or findings (such as settlements) “relating to *an alleged violation*” (emphasis added) of the securities laws, financial or insurance company laws or regulations or business fraud (but not settlements of a civil proceeding among private litigants) and “any sanction or order” of any SRO or other member regulated association.

Finally, as an information point for investors, the new rules require disclosure of whether, and if so, how, a nominating committee "considers diversity" in identifying nominees for director. If a nominating committee has a policy with regard to diversity considerations, disclosure is required concerning its implementation and its effectiveness. As a matter of regulation, however, the SEC expressly stated that it was not defining "diversity," and acknowledged that some companies may conceptualize diversity broadly to include differences of viewpoint, professional experience, education, skill and other qualities and attributes, while others may look to diversity as race, gender and national origin. In any case, the definition is left up to the registrant.

New Disclosure about Board Leadership Structure and the Board's Role in Risk Oversight

The amendments require disclosure of the leadership structure of the board, particularly whether the CEO also serves as Chairman, and if so, whether there is a "lead independent director" and the role that person plays. Under this new disclosure obligation, the registrant must indicate why this form of leadership structure is appropriate given the specific characteristics or circumstances of the registrant. The SEC has stated that these changes are intended to provide investors with more transparency about the company's corporate governance, but are not intended to influence a company's decision regarding its board leadership structure. Because these rules require companies to explain why their board leadership is appropriate, companies will want to review their structure and, in that context, evaluate the Chairman position and "lead independent director" role.

The amendments also require companies to describe the board's role in the oversight of risk. The rules do not prescribe the role of the board; rather, they give companies the flexibility to describe how the board administers risk oversight, whether through the whole board or through the use of board committees, as well as to describe the relationship between the board and senior management in managing the material risks facing the company.

New Disclosure Regarding Compensation Consultants

This is one of the more significant and controversial provisions of the new requirements, which mandates disclosure of fees paid to compensation consultants advising on executive and director compensation and also providing “additional services” to the registrant.

Over the years, so-called “multi-service compensation consulting firms” have found themselves advising compensation committees and sometimes also working at the same time with senior management on a range of compensation and benefit matters across the company (*e.g.*, executive compensation matters, HR consulting, actuarial services and benefits administration).

The amendments were intended (in the words of the SEC) to “facilitate investor’s consideration of whether, in providing advice, a compensation consultant may have been influenced by a desire to retain other engagements by the company.”

The new rules supplement existing disclosure requirements (Item S-K 407(e)(3)(iii)) that already require disclosure of the role of compensation consultants in determining or recommending the amount or form of executive and director compensation, and whether they are retained directly by the compensation committee and the nature of their mandate in advising the committee. They go one step further by forcing “fee disclosure” under the following scenarios:

- **Board and Company Each Have Separate Compensation Consultants:** In this case, there is no fee disclosure required. The SEC release makes clear that “the final rules provide a limited exception to the disclosure requirements for fees paid to other compensation consultants retained by the company *if the board has retained its own consultant that reports to the board”* (emphasis added).
- **Separate Board Compensation Consultant Who Also Provides Services to the Company:** If the board or compensation committee retains its own compensation consultant, and that consultant also provides “additional services” to the registrant, fee disclosure is required if the fees from those “additional services” exceed $120,000 during the fiscal year. In this case, where the board’s consultant also provides “additional services” to the company, disclosure is also required of whether this additional work was recommended by management and approved by the board. If the board has its own compensation consultant, then fee disclosure is

not required for different consultants who work with management and provide services to management.

- **No Separate Board Compensation Consultant:** If the board has not engaged a compensation consultant, fee disclosure is required if management has engaged a consultant to provide advice on executive or director compensation, and that consultant also provides "additional services" to the company in excess of $120,000 during the fiscal year.
- **Exempt Services:** Consulting services that involve providing information in non-customized compensation surveys or services involving only broad based non-discriminatory plans are not treated as "executive compensation consulting services," so that providing such services to the board or management should not trigger disclosure of fees generated by "additional services" provided by that consultant to management.

Time will tell how these disclosure rules impact the multi-service compensation firms, and whether they will foster the growth of independent boutiques, given that no disclosure is required under the "separate consultant" approach. Also, the SEC rejected a rule that would have required disclosure of fees based on a "percentage of revenue test" (*i.e.*, disclosure even under the "separate consultant" scenario, if fees paid by a registrant exceeded a percentage of the consultant's annual revenue).

Finally, the SEC emphasized its neutrality: its fee disclosure rule "does not reflect a conclusion that we believe that a conflict of interest is present when disclosure is required under our new rule, or that a compensation committee or a company could not reasonably conclude that it is appropriate to engage a consultant that provides other services to the company requiring disclosure under our new rule."

Reporting of Shareholder Voting Results

The amendments move disclosure of shareholder voting results from the quarterly (Form 10-Q) and annual (Form 10-K) reports to Form 8-K to allow more timely disclosure of voting results. Form 8-K has been amended to add a new Item 5.07, which requires a company to disclose the results of a shareholder vote within four business days after the meeting at which the vote occurred.

Under its original proposal, the SEC provided an exception for contested elections, recognizing that companies may not have final voting results within the required time period and permitted companies to disclose the preliminary results on Form 8-K within four business days and file an amended report within four days after the final votes are certified. Under the amendments, the SEC expanded this exception for all situations where final voting results could not be determined within the required time period.

Revised Stock and Option Award Disclosure

The value of stock and option awards granted during the fiscal year will now be reported in the Summary Compensation Table and Director Compensation Table based on the aggregate grant date fair value computed in accordance with FASB ASC Topic 718 (formerly known as FAS 123R) instead of on the basis of their dollar amounts determined for financial statement recognition purposes as previously required. In reversing its final December 2006 position and essentially reverting to the valuation approach that had initially been proposed in 2006, the SEC has come full circle and agreed with the commenters that disclosing the aggregate grant date value better reflects the compensation committee's decisions in granting stock and option awards. The SEC also understands that this new disclosure requirement may cause the list of NEOs included in the Summary Compensation Table to change and suggests that in circumstances where a large "new hire" or "retention" grant results in the omission from the Summary Compensation Table of another executive officer whose compensation otherwise would have been reported, the company can report (but is not required to report) the executive officer's compensation to supplement the required disclosures.

The amendments clarify how the value of performance-based awards will be disclosed. The value of the performance-based awards to be reported in the Summary Compensation Table, Grants of Plan-Based Awards Table and Director Compensation Table will be based on the probable outcome of performance conditions as of the date of grant rather than based on maximum performance under the original proposal. The SEC agreed with commenters that suggested reporting values based on maximum performance overstate the intended level of compensation and result in investors misinterpreting compensation decisions. However, the amendments require that the value of performance-based awards based on the maximum value assuming the highest level of performance conditions be disclosed in a footnote. The SEC believes this will permit investors to understand a performance-based award's maximum value without raising unnecessary concerns.

The new changes in reporting the value of stock and option awards will be required when companies provide Item 402 disclosure for a fiscal year ending on or following December 20, 2009. To facilitate year to year comparisons, companies will have to re-compute the value of stock and option awards based on the full grant date fair values for each preceding fiscal year required to be disclosed. Total compensation for such preceding fiscal years will also have to be re-computed, although companies will not be required to include different NEOs for any preceding fiscal year based on re-computing total compensation. This means, for example, that the columns in the Summary Compensation Table for stock and option awards and total compensation will need to be revised to reflect the recalculated values for 2007 and 2008 for any NEO who is included in the 2010 proxy statement (relating to 2009) and who was also listed as a NEO in the 2009 and 2008 proxy statements (relating to 2008 and 2007, respectively).

Next Steps

To prepare for the upcoming proxy season, companies will want to move quickly and begin to immediately address the new rules. Registrants should establish a process to compile, review and analyze the relevant information and to reach conclusions that will be disclosed in the upcoming proxy statement. It will be critical to coordinate between and among the board, board committees and management, as well as seek input from counsel, compensation consultants and auditors. Key steps would include:

- Identifying, reviewing and analyzing compensation programs that have the potential to create risk and determining whether any such programs are "reasonably likely to have a material adverse effect on the company";
- Revising the company's form of director and officer questionnaire to reflect the enhanced director and nominee disclosures, gathering information regarding director experience, qualification attributes or skills and involvement in legal proceedings;
- Addressing the nominating committee's view of diversity;
- Reviewing and analyzing board leadership structure and the board's role in the oversight of risk;
- Reviewing and analyzing the role played by the compensation committee's compensation consultant (*e.g.*, whether services are also provided to the company) and gathering data concerning the services provided by the compensation consultant and the related fees; and
- Calculating the grant date fair value of stock and option awards for fiscal year 2009, re-computing the values for the preceding two years (to the extent the NEO was listed for each of these years) and assessing the impact of the grant date fair value approach including any unintended results due to special one-time equity grants.

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