SEC Proxy Rule Changes Effective for 2010 Proxy Season

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On December 16, 2009, the SEC adopted amendments to its executive compensation and governance disclosure requirements that will require public companies and management investment companies to make new or modified disclosures in their proxy statements and other public filings beginning in February 2010.[1] The disclosure requirements primarily relate to:

- Compensation policies and practices that present material risks to the company
- Compensation table disclosure of the value of stock and option awards to directors and executive officers
- The qualifications and background of directors and director nominees
- Board leadership structure
- Board involvement in risk oversight
- Potential conflicts of interest involving the use of compensation consultants

The SEC also amended its Form 8-K requirements to require earlier disclosure of voting results from shareholder meetings.

The new rules will require companies to make changes not only to their proxy statement disclosures but also to their related corporate governance practices and the design, operation and disclosure of their compensation programs and procedures. For example, as explained in greater detail below, companies will need to undertake an assessment of risks posed by their compensation arrangements, whether or not they conclude that disclosure is required. In some cases, director and officer questionnaires will need to be modified or supplemented to elicit additional information responsive to the rule changes, and board committee charters should be reviewed for any required changes.

Compliance Deadlines

The rule amendments are effective February 28, 2010, except that the amendments concerning the reporting of equity-based awards in the Summary Compensation Table and Director Compensation Table require companies providing disclosure for a fiscal year ending on or after December 20, 2009 to present recomputed disclosure of such awards for each preceding fiscal year. Shortly after adopting the rules, the SEC published a number of Compliance and Disclosure Interpretations (C&DIs) explaining how the February 28, 2010 effective date applies to various filings, including some that could be filed before February 28, 2010 but not become "effective" until later.[2]

Summary of the Rule Changes

Compensation Risk Assessment

The most significant change made by the final rules is a new requirement that companies discuss their compensation policies and practices as they relate to risk management.[3] Companies will be required to discuss their policies and practices in compensating their employees to the extent that risks arising from such policies and practices are reasonably likely to have a material adverse effect on the company. In a change from the proposed rules, this disclosure is now separate from the compensation discussion and analysis section known as "CD&A." This change was made because the compensation risk assessment relates to the compensation of employees generally, in contrast to the CD&A, which relates only to the compensation of the "named executive officers." In preparing this discussion, companies will need to consider the level of risk that employees might be encouraged to take to meet their incentive-compensation targets or conditions.

The rules include a list of generally applicable compensation policies and practices that might warrant discussion:

- Compensation policies and practices at business units:
  - That carry a significant portion of the company's risk profile
  - With compensation structured significantly differently from the rest of the company's business units
  - That are significantly more profitable than other business units
  - Where compensation expense is a significant percentage of the unit's revenues
- Compensation policies that vary significantly from the overall risk and reward structure of the company (such as policies under which bonuses are awarded upon accomplishment of a task for which income and risk to the company extend over a significantly longer period of time)

The rules also provide the following examples of the types of issues that may need to be addressed for the business units or employees discussed (i.e., if the related risks are reasonably likely to cause a material adverse effect):

- The general design philosophy of the company's compensation policies for employees whose behavior would be most impacted by the incentives established by the policies, as such policies relate to or affect risk taking by employees on behalf of the company, and how they are implemented
- The company's risk assessment or incentive considerations, if any, in structuring compensation policies or in awarding and paying compensation
- How the company's compensation policies and practices 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
- ○ The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met in providing incentives for its employees

The proposing release emphasized that companies should evaluate whether discussion of these issues is appropriate in light of their importance to investors based on the individual company's circumstances, and that the level of detail should vary depending on the particular facts of the company or business unit involved. Separately, the CD&A retains its current requirement to discuss, to the extent material, exposure to downside performance risk and cost-benefit analysis with respect to the compensation of named executive officers.

Compensation Table Disclosures for Equity Awards to Eliminate GAAP Expense Framework

Since its adoption in 2006, the SEC's old framework for reporting stock and option awards in the Summary Compensation Table (showing the dollar amount of all outstanding equity awards expensed during the year for financial reporting purposes rather than the aggregate grant date fair value of that year's awards) had been criticized by investors, practitioners, and commentators as potentially misleading and confusing to investors. For example, reporting the expense could result in a negative compensation number in years in which equity awards are forfeited, and using the expense to determine the most highly paid executives for purposes of inclusion in the Summary Compensation Table sometimes resulted in significant variation from year to year for reasons unrelated to companies' compensation decisions. Many companies responded to perceived weaknesses of the old framework by providing "alternative" Summary Compensation Tables using the aggregate grant date fair value of awards.

The new rules unwind the old framework and require companies to report each year's stock and option awards in the Summary Compensation Table and Director Compensation Table using the aggregate grant date fair value of the awards computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718 (formerly FAS 123(R)). The new rules also clarify that stock and option awards with performance conditions will be reported in the Summary Compensation Table and the Director Compensation Table at a value based on the probable outcome of the conditions, with a footnote to the table disclosing the value of the award assuming that the highest level of performance conditions is achieved (assuming that the highest level of performance was also not the probable outcome included in the table).

Companies reporting stock and option awards for their named executive officers for a fiscal year ending on or after December 20, 2009 will be required to present these amounts for 2009 as well as recomputed disclosure for each preceding fiscal year (i.e., 2007 and 2008, for calendar year end companies), but will not be required to include different named executive officers for any preceding fiscal year based on re-computing total compensation for those years, or to amend prior disclosure.

Director and Director Nominee Qualifications

The new rules expand required disclosures regarding directors and director nominees. Companies will be required to disclose the specific experience, qualifications, attributes, and skills of each director and nominee that led to the conclusion that the person should serve as a director of the company, when considered in light of the company's business and structure. The expanded disclosure requirements will apply to incumbent directors and nominees selected by the company and to any nominees put forward by other proponents. Companies also will be required to disclose any public company directorships held by each director and nominee at any time during the past five years, rather than current directorships only.

Director, Director Nominee, and Executive Officer Legal Proceedings

The existing requirement to disclose certain bankruptcy-, criminal-, or securities-related legal and similar proceedings involving directors and executive officers was expanded to cover the preceding 10 years, rather than, as under the previous rules, the preceding five years. The final rules also added two additional categories of legal proceedings to the list triggering disclosure.

Director Diversity Policy

The final rules expand the required disclosure concerning nominating committees' processes for identifying and evaluating nominees for director. Now, companies must disclose whether and how their nominating committees or boards consider diversity in identifying nominees for director. The SEC did not define diversity in the final rules, allowing for variation among companies. The SEC suggested that some companies may include in their conceptions of diversity such items as differences of viewpoint, professional experience, education, skill and other individual characteristics that contribute to board heterogeneity, while others may focus on characteristics such as race, gender and national origin.

Under the final rules, the implementation of any policy with regard to the consideration of diversity in identifying director nominees must be described, as well as how the nominating committee or the board assesses the effectiveness of such policy. Companies may wish to review their nominating committee charters or director selection criteria to ensure that they are comfortable with the form their disclosure concerning board diversity will take in light of, for example, the conception of diversity presented and the current composition of the board.

Board Leadership Structure

Under the new rules, companies will be required to disclose the leadership structure of their boards of directors and justify it, providing an explanation for why they believe their structure is appropriate given their specific characteristics or circumstances. Companies will be required to disclose specifically whether and why they have combined or separated the principal executive officer and board chair positions and, if they have combined principal executive officer and board chair positions, whether they have a lead independent director and the specific role that any lead independent director has in the leadership of the company.

Board Role in Risk Oversight

Under the new rules, companies will be required to disclose the extent of the board's role in risk oversight, such as how the board administers its risk oversight function and the effect that this has on the board's leadership structure. This disclosure might include, for example, whether the company's risk management function is implemented and managed by the entire board or through a committee and whether the persons overseeing risk management report to the board or a committee.

Conflicts of Interest Involving Compensation Consultants

Consistent with the proposed rules, the final rules include new disclosures intended to address potential compensation consultant conflicts of interest, although the circumstances in which the additional disclosures are required have been curtailed somewhat from the original proposal. Fee disclosure related to the retention of a compensation consultant will be required as follows:

- If the compensation committee (or the board or other persons performing similar functions) engages its own consultant to provide advice or recommendations on the amount or form of executive and director compensation and the consultant or its affiliates provide additional services to the company, disclosure of fees paid for both types of services is required if the fees for the additional services exceed $120,000 during the company's fiscal year. If this disclosure is required, companies also must disclose whether the decision to engage the compensation consultant for the additional services was made or recommended by management and whether the board or compensation committee has approved the services.
- If the compensation committee (or the board or other persons performing similar functions) has not engaged its own consultant, fee disclosures are required with respect to any consultant or its affiliates providing advice or recommendations on the amount or form of executive and director compensation, as well as additional services, through an engagement with management, if the fees paid for the additional services exceed $120,000 during the company's fiscal year.
- Fee and related disclosure for consultants who work with management is not required if the board has its own, distinct consultant, regardless of whether the fees paid exceed $120,000.
- Services involving only broad-based non-discriminatory plans or the provision of

information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant, are not treated as "advice or recommendations on the amount or form of executive and director compensation" for these purposes.

Form 8-K Disclosure of Shareholder Voting Results

Currently, companies are required to report the results of shareholder votes in the periodic report for the period in which the vote was taken. Consequently, results of shareholder votes may not be disclosed until some time after the vote is taken. Under new Item 5.07 of Form 8-K, companies will be required to report within four days after they submit any matter to a shareholder vote (i) the date of the meeting and whether it was an annual or special meeting; (ii) if the meeting involved the election of directors, the name of each director elected, a brief description of each other matter, and the voting results; and (iii) the terms of any settlement between the company and any other participant terminating any solicitation subject to Rule 14a-12(c) under the Securities Exchange Act of 1934, as amended. Companies will be required to disclose preliminary voting results within four business days, followed by an amendment with final voting results, unless they are able to disclose final voting results within four business days.

Rules for Management Investment Companies

The new rules made similar changes to the disclosure required by management investment companies, such as mutual funds registered under the Investment Company Act of 1940.

Practice Tips

Since the rule amendments are generally effective for the 2010 proxy statements, calendar-year companies that are affected by the changes will need to adapt quickly. Some recommendations for specific responses to the final rules are set forth below.

Recommended Process for Compensation Risk Assessment

Compensation committees should consider taking the following actions in coordination with management to implement the final rules on compensation risk assessment:

- Identify material internal and external risks in the context of the company's business activities and markets of operation
- Determine how compensation practices and arrangements influence these risks
- Identify policies that will mitigate or limit these risks but still align compensation to the achievement of company's strategic plan
- Meet with the senior risk officer (or equivalent officer) to assess risk in executive compensation

- Consult with outside experts
- Document the foregoing assessments in committee minutes, if appropriate, and disclose in the proxy statement (if applicable)

Compensation committees should consider and document key factors and practices relating to compensation risk, including, potentially, longer-term performance periods, the alignment of compensation with the company's strategic plan, both upside potential and downside risks and consideration of both absolute and relative metrics (including peer group comparisons when practical). Potential compensation risk "red flags" include such practices as uncapped upside potential in incentive arrangements, incentives tied to a short timeframe, incentives to "swing-for-the-fence," equity awards with limited downside risks, and a misaligned mix between base salary and incentive compensation

Update or Supplement Director and Officer Questionnaires

Companies should ensure that their director and officer questionnaires solicit the information that will be required in 2010 proxy statements such as the specific qualifications of directors for board service and certain legal proceedings over the previous 10, rather than five, years. In addition, due to the final rules' addition of two new categories of legal proceedings that were not in the proposed rules, any director and officer questionnaires that have been updated based on the proposed rules will likely need to be modified or supplemented to include questions on these categories.

Revisit Determination of Named Executive Officers

The revised method of reporting equity awards under the rule amendments may change the identity of the most highly paid executive officers, thereby resulting in a change to the "named executive officer" group for whom proxy statement disclosure of compensation is required. Accordingly, companies should revisit this determination early in the process of preparing their proxy statements.

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[1] SEC Release No. 33-9089.

[2] The C&DIs are available at http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm

[3] Smaller reporting companies will not be required to provide the new compensation risk disclosures.