SEC Approves Enhanced Disclosure Rules for Compensation, Risk Oversight and Corporate Governance

On December 16, 2009, the Securities and Exchange Commission ("SEC") adopted amendments (the "Amendments") to the disclosure requirements relating to executive compensation, risk oversight, board leadership and composition and other corporate governance matters under the Securities Exchange Act of 1934, as amended (the "Exchange Act").[1] The SEC approved the final rules by a 4-to-1 vote, with Commissioner Kathleen Casey dissenting.[2]

The effective date of the Amendments is February 28, 2010. However, the parts of the Amendments requiring presentation of equity compensation awards at grant date fair value in companies' Summary Compensation Tables apply to all companies with fiscal years ending after December 20, 2009 and require presentation on a comparable basis for prior years' awards. Companies should also consider updating their director and officer questionnaires for the upcoming proxy season to address the new director and officer disclosure requirements discussed below. On December 22, 2009, the staff of the SEC's Division of Corporation Finance provided detailed transition guidance in Compliance and Disclosure Interpretations regarding the effective date for the Amendments. A summary of this guidance is attached hereto as Annex A.

The Amendments were proposed in July 2009 (the "Proposed Rules") to provide investors with additional useful and meaningful information to enhance their ability to make informed voting and investment decisions.[3] The SEC received over 130 comment letters on the proposals and the Amendments reflect a number of changes from the initial proposals. The SEC did not adopt proposed amendments relating to the proxy solicitation process, including proposed amendments related to "short slates" of director nominees. At the

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1 *Final Rule: Proxy Disclosure Enhancements,* Release No. 33-9089 (December 16, 2009), *available* at http://www.sec.gov/rules/final/2009/33-9089.pdf (the "Adopting Release").

2 *See* Speech by SEC Chairman Mary L. Schapiro, December 16, 2009, at http://www.sec.gov/news/speech/2009/spch121609mls-proxy.htm. Video of the open meeting is archived at http://www.sec.gov/cgi-bin/goodbye.cgi?www.connectlive.com/events/secopenmeetings/. *See also* Speech by SEC Commissioner Kathleen L. Casey, December 16, 2009, http://www.sec.gov/news/speech/2009/spch121609klc.htm. Commissioner Casey generally supported the amendments, but expressed concern about requiring additional disclosure of director nominees' qualifications on a person-by-person basis, as opposed to allowing boards to consider the desired qualifications of the board as a whole. She also expressed concerns about requiring additional disclosure regarding boards' consideration of diversity in selecting director nominees and disclosure assessing implementation of diversity policies.

3 *See Proposed Rule: Proxy Disclosure and Solicitation Enhancements,* Release No. 33-9052 (July 10, 2009), *available at* http://sec.gov/rules/proposed/2009/33-9052.pdf (the "Proposing Release").

December 16 open meeting, the SEC staff (the "Staff") recommended deferring consideration of those proposed amendments to be considered together with the SEC's proposed proxy access rule in 2010.[4]

1. Effects of Compensation Policies and Practices on Risk Management

The Amendments revise the executive compensation disclosure rules to require companies to discuss and analyze their compensation policies and practices for all employees, not just executive officers, to the extent the compensation policies and practices create risks that are "reasonably likely to have a material adverse effect" on the company.[5] The Proposed Rules would have required disclosure in the compensation discussion and analysis ("CD&A") section of a proxy statement of compensation policies and practices applicable to employees if they create risks that "may have a material effect" on the company. However, the Amendments adopted provide that the disclosure will be moved into a separate disclosure section and will not be a part of the CD&A. The Amendments also apply a higher disclosure threshold than that originally proposed and only require a company to address compensation policies that create risks that "are reasonably likely to have a material adverse effect on the company." Smaller reporting companies not subject to the CD&A requirements will be exempt from these new requirements as well. Also, a company is not required to state affirmatively that it has determined its compensation policies are not reasonably likely to have a material adverse effect on the company.

While the situations requiring disclosure of the relationship of compensation policies to risk management will vary depending on the particular company and its compensation policies and practices, the amended rules provide that situations that may trigger this additional disclosure requirement include compensation policies and practices:

- at a business unit of the 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;

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4 On December 14, 2009, the SEC re-opened the comment period for the June 2009 shareholder proxy access proposal. The new comment period ends January 19, 2010. *See Facilitating Shareholder Director Nominations*, Release No. 33-9086 (December 14, 2009), available at http://www.sec.gov/rules/proposed/2009/33-9086.pdf; *Proposed Rule: Facilitating Shareholder Director Nominations*, Release No. 34–60089 (June 10, 2009), available at http://www.sec.gov/rules/ proposed/2009/33–9046.pdf. For a more detailed discussion of the June 2009 Release, see *Update-SEC Publishes Proposed Rule Amendments to Facilitate the Rights of Shareholders to Nominate Directors* (July 14, 2009), available at http://www.cahill.com/news/memoranda/000178.

5 *See* new Item 402(s) of Regulation S-K.

- at a business unit where 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 amended rules provide examples of situations in which a company's compensation policies and practices may trigger enhanced disclosure, as well as examples of issues a company may be required to address if it determines its compensation policies or practices are reasonably likely to have a material adverse effect on the company, including:

- the general design philosophy of a company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by 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 and practices 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 and practices to address changes in its risk profile;

- material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and

- the extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

Disclosure should focus on the relationship between the compensation policies and risk, addressing issues such as the examples noted above, including a discussion of policies applicable to employees who are not Named Executive Officers,[6] but will not require disclosure of compensation amounts for other

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[6] Named Executive Officers include (i) all individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year ("PEO"), regardless of compensation level; (ii) all individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year ("PFO"), regardless of compensation level; (iii) the registrant's three most highly compensated executive officers other than the PEO and PFO who were

(footnote continued on following page)

employees. Also, in assessing whether disclosure is required, companies can consider controls and other elements that may mitigate the probability or potential impact of compensation policies that might otherwise create risks. The SEC emphasized that disclosure should be specific to the particular situation at each company and should not be generic or boilerplate.

2. Disclosure of Stock and Option Awards in the Summary Compensation Table and Director Compensation Table

The Amendments also alter the disclosure requirements for the Summary Compensation Table and Director Compensation Table, which were implemented with the 2006 proxy disclosure regulations, to require companies to include the grant-date fair value of equity awards made during the fiscal year rather than the dollar amount recognized as an expense for financial statement reporting purposes.[7] The grant-date fair value will include the aggregate value of all stock or option awards, including performance awards, excluding the effect of foreclosures granted during the fiscal year, currently disclosed in the Grants of Plan-Based Awards Table and valued in accordance with applicable financial accounting standards (FASB Accounting Standards Codification Topic 718, formerly referred to as SFAS 123R). The Amendments include an instruction clarifying that the value of stock and option awards with performance conditions is the value at grant date based on the probable outcome of the performance condition, assessed as of the grant date of the awards (typically, the "target" award value); the maximum potential value must appear in a footnote.[8]

These Amendments will impact the calculation used to identify Named Executive Officers since the calculation will be based upon total compensation using the grant-date fair value of equity awards made during the year rather than the expensed accounting value. Companies with a fiscal year ending on or after December 20, 2009 will use this value to identify the current year's Named Executive Officers and will be required to apply this method to recompute the value of compensation disclosed for those Named Executive Officers in the Summary Compensation Table for the last two fiscal years. However, companies are not required to add different Named Executive Officers for prior years based on recomputing total compensation pursuant to the Amendments.

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serving as executive officers at the end of the last completed fiscal year; and up to two additional individuals for whom disclosure would have been provided pursuant to clause (iii) but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year. *See* Item 402(a)(3) of Regulation S-K.

7 *See* new Items 402(c)(2)(v) and (vi), 402(k)(2)(iii) and (iv), 402(n)(2)(v) and (vi), and 402(r)(2)(iii) and (iv) of Regulation S-K.

8 *See* Instruction 3 to Item 402(c)(2)(v) and (vi), Instruction 8 to Item 402(d), and Instruction 3 to Item 402(n)(2)(v) and (vi) of Regulation S-K.

3. Additional Director and Officer Disclosure

The director and officer biographical disclosure rules have been amended to require that companies provide additional disclosure for all directors, including director nominees and directors not up for re-election but who will continue to serve following the election with respect to the following:

- the specific experience, qualifications, attributes and skills of a director or director nominee that led to the conclusion that the person should serve as a director at the time the disclosure is made, in light of the company's business and structure;[9]

- all public company directorships held by directors and director nominees during the past five years (rather than just current directorships, as required under the present rules);[10] and

- the involvement of directors, director nominees and executive officers in legal proceedings during the prior ten years (rather than five years, as required under the present rules). The list of legal proceedings covered by the rule has also been expanded to include involvement in mail or wire fraud or fraud in connection with any business entity, proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement of such actions and disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization. Disclosure of settlements of civil proceedings among private parties is not required.[11]

The Adopting Release does not specify the particular information that needs to be disclosed to meet these requirements, but since these changes were adopted as part of the rules addressing the business experience of directors, disclosures will likely reflect the input and assessment of a board nominating committee, or full board, in reaching a "conclusion" that a person is qualified and appropriate to be nominated or to serve as a director.

4. Diversity Considerations in the Director Nomination Process

The disclosure requirements applicable to board nominating committees have been amended to require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees

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9 *See* revised Item 401(e)(1) of Regulation S-K. The Proposed Rules would also have required disclosing how these factors related to service on board committees. The Amendments do not require disclosure of qualifications to serve on a committee or the risk assessment skills of a director, but if such qualifications or skills led the board to select a director for a particular committee they should be disclosed.

10 *See* revised Item 401(e)(2) of Regulation S-K.

11 *See* new Item 401(f)(7) and Item 401(f)(8) of Regulation S-K.

for director.[12] If the nominating committee or board has adopted a diversity policy, the Amendments require a discussion of how the nominating committee or board implements and assesses the effectiveness of the policy. The adopted rules do not specify a definition of "diversity" but rather allow companies to define diversity in ways that they consider appropriate. According to the Adopting Release, "some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin."[13]

5. Board Leadership Structure and Risk Oversight

The Amendments require a discussion of:

- a company's board leadership structure, including whether the company has combined or separated the chief executive officer and chairman position;
- if one person serves as both chief executive officer and chair of the board, whether the company has a lead independent director and the specific role of such director in company leadership; and
- why the company believes its structure is the most appropriate for the company at the time of the filing.[14]

The Amendments also require disclosure of the extent of the board's role in the risk oversight of the company, including a description of how the board administers its oversight function, such as through the whole board, a separate risk committee or the audit committee.[15] The effect of the risk oversight function on the board's leadership structure also is required to be discussed, such as how the risk oversight function is coordinated if board committees are responsible for different aspects of the oversight function. The new disclosure focuses on risk oversight, not risk management (in contrast to the initial proposals). Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management

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12 *See* revised Item 407(c)(2)(vi) of Regulation S-K.

13 *See* Adopting Release, *supra* note 1.

14 *See* new Item 407(h) of Regulation S-K and corresponding amendment to Item 7 of Schedule 14A. With respect to management investment companies that are registered under the Investment Company Act, the Amendments require expanded disclosure regarding director and nominee qualifications; past directorships held by directors and nominees; and legal proceedings involving directors, nominees, and executive officers to funds; and new disclosure about leadership structure and the board's role in the oversight of risk. See Amended Forms N-1A, N-2 and N-3.

15 *See* new Item 407(h) of Regulation S-K.

responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals.

6. Disclosure About Compensation Consultants

The Amendments expand the disclosure requirements relating to board compensation committees to require enhanced disclosure of fees paid to certain compensation consultants that provide advice to the board or compensation committee regarding executive or director compensation and also provide other services to the company.[16] If the board or compensation committee has engaged its own compensation consultant and the consultant or its affiliates provides other services to the company (not involving the amount or form of executive and director compensation) for which fees in excess of $120,000 were paid during the fiscal year, then the company is required to disclose:

- the aggregate fees paid for advising on the amount or form of executive and director compensation and the amount paid for the additional services;
- whether the decision to engage the consultant or its affiliates for such additional services was made by or recommended by management; and
- whether the board or compensation committee approved the other services.

If the board or compensation committee has not engaged its own compensation consultant, but management has retained a consultant to advise on amounts or forms of executive compensation and the consultant or its affiliates provides other services to the company for which fees in excess of $120,000 were paid during the fiscal year, the company is required to disclose the aggregate amount of fees paid for advising on executive compensation and for the other services.

7. Reporting of Voting Results on Form 8-K

The Amendments will now require companies to disclose, pursuant to a new Item 5.07 of Form 8-K, the voting results from shareholder meetings within four business days after the end of the meeting. This replaces the requirement to disclose voting results in Forms 10-K and 10-Q. An instruction has been added to Form 8-K that if final results are not known within four business days of the meeting, then preliminary voting

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16 *See* revised Item 407(e) of Regulation S-K. The Amendments are more specific than the Proposed Rules in defining when additional disclosures are required and include an exception if the executive and director compensation services are limited to broad-based plans that do not discriminate in favor of executive officers or directors or to providing general information, such as surveys, that is not tailored for the company or is based on parameters that are not developed by the consultant and about which the consultant does not provide advice.

results must first be filed and an amended Form 8-K must be filed within four business days of the availability of the final results of the shareholder vote.[17]

8. Additional Considerations

The Staff has reiterated its determination to continue to evaluate compliance with the existing executive compensation disclosure rules, especially in the context of disclosing performance goals used in determining the amount of executive compensation awarded to Named Executive Officers.

In a November 2009 speech, SEC Deputy Director Shelley Parratt, who oversees the review of all public company filings, reiterated the message that a company should disclose, in its CD&A, performance targets that are material to its compensation policies and decisions.[18] With respect to the threshold determination of whether a performance target is material, Ms. Parratt stated that "[t]he fact that a performance target was not met or was otherwise disregarded may be a factor to consider in the materiality determination, but it is not a dispositive one." Ms. Parratt explained that in most cases, including cases where no payouts are made, companies should disclose performance targets. Ms. Parratt went on to address disclosure of performance targets where a company has determined such targets to be material, unless such disclosure would cause substantial competitive harm. She explained that, while the Staff paid particular attention to competitive harm comments and responses with respect to 2009 disclosures and accepted omission of specific targets where companies adequately explained the nexus between disclosure and potential harm, the Staff has "yet to see" the competitive harm standard satisfied with respect to disclosure of performance targets tied to company-wide financial results that have been publicly reported. In a discussion of what to expect from the comment process in 2010, Ms. Parratt advised that, instead of addressing disclosures in future filings, the Staff will require companies to prepare amended filings if the Staff determines that a company's disclosures (or lack of disclosures) do not materially comply with the proxy rules.

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17 *See* Instruction 1 to Item 5.07 of Form 8-K.

18 *See* Speech by SEC Staff: Deputy Director, Division of Corporation Finance Shelley Parratt: Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010, The 4th Annual Proxy Disclosure Conference: Tackling Your 2010 Compensation Disclosures, San Francisco, California November 9, 2009, at http://www.sec.gov/news/speech/2009/spch110909sp.htm.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com; or Lindsay Flora at 212.701.3429 or lflora@cahill.com; or Dan Zimmerman at 212.701.3777 or dzimmerman@cahill.com.

Annex A
Summary of SEC Compliance and Disclosure Interpretations

The staff of the SEC's Division of Corporation Finance has provided guidance for companies on transitioning to the Amendments. The Compliance and Disclosure Interpretations posted on December 22, 2009, present interpretations of how the Amendments' effective date applies to the filing of proxy statements, Form 10-Ks, Form 8-Ks, Securities Act registration statements and Exchange Act registration statements.[19] A summary of this guidance is included below.

- If a company's fiscal year ends on or after December 20, 2009, its Form 10-K and related proxy statement must be in compliance with the Amendments if filed on or after February 28, 2010. If such a company is required to file a preliminary proxy statement and expects to file its definitive proxy statement on or after February 28, 2010, then the preliminary proxy statement must be in compliance with the Amendments, even if filed before February 28, 2010. If such a company files its 2009 Form 10-K before February 28, 2010 and its proxy statement on or after February 28, 2010, the proxy statement must be in compliance with the Amendments.

- If a company's fiscal year ends before December 20, 2009, its 2009 Form 10-K and related proxy statement are not required to be in compliance with the Amendments, even if filed on or after February 28, 2010.

- A company with a 2009 fiscal year that ends before December 20, 2009 will not be required to comply with the Amendments until the filing of its Form 10-K for fiscal year 2010. As a result, any Securities Act or Exchange Act registration statements for such a company filed before the 2010 Form 10-K is required to be filed would not be subject to the Amendments.

- A company may comply on a voluntary and discretionary basis with the Summary Compensation Table and Director Compensation Table amendments, but only if it also complies with all other Regulation S-K amendments adopted in the Adopting Release that apply to the form filed. Companies may provide the other new disclosures without having to comply with all of the Amendments.

- Any companies that are new registrants and file a registration statement on or after December 20, 2009 must comply with the Amendments in order for the registration statement to be declared effective on or after February 28, 2010.

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[19] *See* Proxy Disclosure Enhancements Transition (December 22, 2009), *available at* http://sec.gov/divisions/corpfin/guidance/pdetinterp.htm.

- Any shareholder meeting that takes place on or after February 28, 2010 is subject to the new Form 8-K Item 5.07 reporting requirement. If the meeting takes place before February 28, 2010, an Item 5.07 Form 8-K is not required, regardless of whether the proxy statement for the meeting was mailed to shareholders before that date.