Bah Humbug! SEC Expands Risk, Compensation and Corporate Governance Disclosures for 2010 Proxy Season

The SEC's recent adoption of rules aimed at increasing corporate accountability will require companies to address new disclosures in proxy and information statements.

In what may appear to be the beginning of an eerie tradition,[1] on December 16, 2009, the Securities and Exchange Commission ("SEC") adopted rules[2] which, among other matters, will require companies to address new disclosures in proxy and information statements concerning:

- director and director nominee qualifications and experience;
- board leadership structure and the board's role in risk oversight;
- executive compensation and risk management;
- stock and option awards to company executives and directors; and
- potential conflicts of interest of compensation consultants.

In addition, the new rules expedite the disclosure of shareholder voting results, requiring such results to be presented on Form 8-K within four business days after the meeting at which the vote was held.

Aimed at increasing corporate accountability, SEC Chairperson Mary L. Schapiro indicated, "[b]y adopting these rules, we will improve the disclosure around risk, compensation and corporate governance, thereby increasing accountability and directly benefiting investors."

Expanded Director and Director Nominee Disclosures

In an effort to enhance disclosures concerning directors and director nominees, the new rules require a discussion of the particular experience, qualifications, attributes or skills (including, if applicable, risk assessment skills or skills relevant to service on a board committee) that led to the conclusion that such person should serve as a director. This disclosure will be required for all directors regardless of whether the director is up for reelection and is in addition to the SEC's current disclosure requirements that mandate a discussion of each director's and director nominee's business experience during the past five years.

The new rules will also require disclosure of any directorships held by each director and director nominee at public companies at any time during the previous five years (as opposed to only current directorships) and lengthen the time during which disclosure of legal proceedings is required from five to 10 years. In addition, the list of legal proceedings requiring disclosure is expanded under the new rules to include:

- any judicial or administrative proceedings (1) resulting from involvement in mail or wire fraud or fraud in connection with any business entity or (2) based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement to such actions; and
- any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

1 On December 22, 2006, the SEC adopted rules concerning the valuation of stock and option awards in the Summary Compensation Table and Director Compensation Table applicable to the 2007 proxy season.

2 A copy of the adopting release is available at: http://www.sec.gov/rules/final/2009/33-9089.pdf

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An instruction to the new rules clarifies that disclosure regarding private civil proceedings will not be required.

Finally, the new rules will require disclosure regarding the consideration of diversity in the selection of board nominees. Companies will be permitted under the new rules to define diversity in a manner that they consider appropriate (e.g., professional experience, education, gender, national origin, etc.).

Board Leadership Structure and Risk Oversight

The new rules will also require disclosure concerning the company's board leadership structure. For example, the new rules require disclosure regarding whether and why the company has chosen to separate or combine the role of principal executive officer and board chair positions. If these positions are combined, the company will be required to disclose whether it has a lead independent director and what specific role the lead independent director plays in its leadership structure. Lastly, the new rules will also add disclosure concerning the board's role in the risk oversight of the company, such as how the board administers its oversight function and the effect this has on the board's leadership structure.

Enhanced Executive Compensation and Risk Management Disclosures

In an attempt to help investors determine whether a company has incentivized excessive or inappropriate risk taking, the new rules will require additional disclosure regarding the extent to which risks arising from the company's compensation policies and practices are reasonably likely to have a material adverse effect on the company. In an important shift from the SEC's July 2009 proposed rules, the SEC heightened the standard for disclosure from those policies and practices that ***may have a material effect on the company*** to those policies and practices that ***are reasonably likely to have a material adverse effect on the company***.

Companies would be required to discuss their policies or practices of compensating employees, including non-executive officers, as they relate to risk management practices and/or risk-taking incentives in this regard. As the new rules would require disclosure with respect to all employees, including non-executive officers, the narrative would be presented outside of the company's Compensation Discussion and Analysis.

The new rules state that the situations requiring disclosure will vary depending on the particular company, but that situations that may trigger disclosure include, among others, 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 business units that are significantly more profitable than others within the company;
- at business units 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 new rules further state that the information to be disclosed may vary depending upon the nature of the company's business and compensation approach, but that the following are examples of the issues that the company may need to address for the business units or employees discussed:

- the general design philosophy of the company's compensation policies and practices for employees whose behavior would be most impacted 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 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 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.

Consistent with the SEC's general practice, the new rules do not require the company to affirmatively assert a negative. The company will not be required to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

Stock and Option Awards Presented at the Grant Date Fair Value in the Year of the Award

The new rules will also revise the Summary Compensation Table ("SCT") and the Director Compensation Table ("DCT") to require disclosure of the aggregate grant date fair value of stock and option awards computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, formerly referred to as FAS 123R, for awards granted during the relevant fiscal year. Prior to the adoption of the new rules, companies reported the amount recognized for financial statement reporting purposes for the fiscal year in the SCT and DCT. Under the new rules, large one-time stock and option awards have greater potential for altering the makeup of the company's named executive officers.

A special instruction under the new rules indicates that the value of performance awards will be based upon the "probable outcome" of the performance conditions on the grant date. The instruction is an attempt by the SEC to reduce the potential for overstating the award in the SCT and DCT (and related discouraging effect on companies in granting performance based awards). The maximum value of performance based awards would however, still be required to be disclosed in the Grants of Plan-Based Awards Table and a footnote to the SCT and DCT.

In a movement contrary to the SEC's July 2009 proposed rules, the SEC ultimately determined not to rescind the requirement to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Award Table and corresponding footnote disclosure to the DCT (companies will continue to be required to report the grant date fair value of awards in the Grants of Plan-Based Awards Table and a footnote to the DCT).

Compensation Consultant Disclosures

The new rules also elicit, for the first time, disclosure concerning fees paid to compensation consultants when the consultant played a role in determining or recommending the amount or form of executive and director compensation, and also provided additional services to the company.

Aimed at highlighting potential conflicts of interest, under the new rules, if a compensation consultant had a role in determining or recommending director or executive compensation (other than broad-based plans and non-customized services) during the company's last completed fiscal year, then the company must disclose:

- the identity of such consultant;
- who engaged the consultant;
- the scope of the consultant's assignment and the material instructions given to such consultant; and
- if the consultant provided additional services to the company in excess of $120,000 during the last completed fiscal year (i.e., consulting services other than with respect to director or executive compensation), then the company must also disclose (A) the aggregate fees paid to the consultant for executive or director compensation services and the aggregate fees for such additional services, (B) if the compensation consultant was retained by the board or compensation committee, whether the decision to engage such compensation consultant was recommended by management and (C) if the compensation consultant was retained by the board or compensation committee, whether the compensation committee or board approved such additional services.

Current Report on Form 8-K Disclosure of Voting Results

Lastly, the adopting release amends Current Report on Form 8-K to require companies to disclose the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. If results are not known by the deadline, companies would be permitted to disclose preliminary voting results and file an amended Current Report on Form 8-K within four business days of final results being known.

Effective Date and Transition

The new rules will become effective on **February 28, 2010**. Although the SEC's adopting release is not free from ambiguity, it is believed that the SEC intends for the new rules to be applicable to filings made on or after February 28, 2010. The new rules leave unanswered many questions regarding transition and timing of required implementation. Companies should continue to monitor SEC guidance in this regard.

Suggested Actions

Given the significant impact of these developments and the limited period of time to implement the new rules, companies should consider the following:

- **Revise D&O Questionaires.** The new rules require more fulsome detail concerning each director and director nominee's experience and qualifications as well as lengthen the time periods applicable to disclosures regarding other directorships and legal proceedings.
- **Model Disclosures.** In the near term, consider the impact of the new rules on the company's disclosures and begin to model revised disclosures in light of the new rules.
- **Review Compensation and Nominating Committee Charters.** Consider whether amendments to the company's compensation and/or nominating committee charters are appropriate in light of the new rules.
- **Assess Compensation Consultant Independence.** Given the enhanced scrutiny of compensation consultant independence under the new rules, a critical assessment of potential conflicts of interest and propriety of fees paid will need to be considered.

If you have any questions about the matters addressed in this *Kirkland Governance Watch*, please contact the following Kirkland authors or your regular Kirkland contact.

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