

ClientAlert

December 22, 2009
(Revised)

SEC Approves Final Rules on Enhanced Executive Compensation and Corporate Governance Proxy Disclosure

On December 16, 2009, the Securities and Exchange Commission approved final rules that enhance the executive compensation and corporate governance disclosures that companies are required to include in their proxy statements and other reports filed with the SEC.¹ The final rules are substantially similar to the rules that the SEC proposed in July 2009, which were described in our July 28, 2009 [Client Alert](#). The final rules require:

- disclosure of how compensation policies and practices affect risk management;
- discussion of the role the board plays in the risk oversight process;
- discussion of board leadership structure, *e.g.*, why a company has decided to combine (or separate) the roles of board chair and CEO;
- disclosure of consideration by the nominating committee of diversity in the director nomination process;
- disclosure of additional information about the background and qualifications of directors and nominees, legal proceedings involving executive officers, directors and nominees and potential conflicts with compensation consultants; and

- inclusion of the aggregate grant date fair value of equity awards in the Summary Compensation Table and Director Compensation Table rather than the amount recognized annually for financial statement reporting purposes.

The SEC also approved rules requiring disclosure of shareholder voting results within four business days on a Form 8-K.

The SEC has decided to defer its consideration of proposed amendments to the proxy solicitation process included in the proposing release pending its continuing consideration of its separate proposal relating to shareholder director nominations in companies' proxy materials.

The rules become effective on February 28, 2010 for issuers with fiscal years ending on or after December 20, 2009. On December 22, 2009 the SEC staff issued guidance on transition issues surrounding the effective date, including clarifying that the new rules will apply to preliminary proxy statements filed before that date if the definitive proxy statement is expected to be filed after that date.

Compensation Policies and Risk Management

The final rules require a company to disclose in its proxy statement, separate from its CD&A, how its compensation policies or practices create incentives that can affect risks and to disclose how the company manages those risks. Unlike the CD&A, this disclosure is not limited to

¹ SEC Release Nos. 33-9089; 34-61175; IC-29092; File No. S7-13-09. A copy of the release is available on the SEC's website at www.sec.gov/rules/final/2009/33-9089.pdf.

policies or practices affecting executive officers and this disclosure is only required if the company's policies or practices create risks that are reasonably likely to have a material adverse effect on the company. Consequently, the requirement to provide this disclosure will vary depending on the company and its compensation policies and practices and may not be required at all. Situations that may trigger disclosure include policies and practices at a business unit that:

- carries a significant portion of the company's risk profile or is significantly more profitable than others within the company;
- has a significantly different compensation structure than other units or has compensation expense that is a significant percentage of the unit's revenues; or
- 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.

In response to comments, the SEC modified its proposed rules in several respects. First, the SEC imposed a higher disclosure threshold ("reasonably likely to have a material adverse effect") from the threshold described in the proposing release ("may have a material effect"). The higher threshold is similar to the MD&A disclosure threshold and is intended to elicit only those disclosures that would be most relevant to investors and would allow companies to consider mitigating factors (*e.g.*, clawbacks) designed to limit risks of certain compensation arrangements in its assessment. Second, the disclosure threshold in the final rules requires that the effect be *adverse*. The disclosure will not be included in the CD&A as was contemplated in the proposing release. Instead, the disclosure

will be separate from CD&A to avoid the confusion that may have arisen if the CD&A were to be expanded beyond a company's named executive officers to include a discussion of compensation policies applicable to all employees (as required by the new rules). Unlike the proposed rules, under the final rules a company that determines that risks arising from its compensation practices are not reasonably likely to have a material adverse effect will not be required to include an affirmative statement to that effect. As proposed, smaller reporting companies will be exempt from providing the new disclosure.

Board Leadership Structure and Board's Role in Risk Oversight

The final rules require a company to describe the leadership structure of its board of directors in its proxy statement and also discuss why the company believes it is the best structure for its board at the time of the filing. In connection with this disclosure, companies will be required to disclose whether and why they have chosen to combine or separate the principal executive officer and board chair positions. A company that combines the principal executive officer and board chair roles would be required to disclose whether the company has a lead independent director and the reasons, as well as the specific role the lead independent director plays in the leadership of the company. The final rules clarify that it is the leadership structure of the board that should be described, not the structure of the company's management.

The board's role in the oversight of risk would also need to be disclosed. Under the new rules, companies will have flexibility to describe how the board administers its risk oversight function (*e.g.*, through the whole board or through a separate committee). The SEC noted that companies may want to disclose, where

applicable, whether individuals with day-to-day risk management responsibilities report directly to the board (or a committee) or how the board otherwise receives information from such individuals. The final rules differ from the proposed rules in one technical respect. The proposed rules would have required disclosure of the board's role in the *risk management* process. The final rules use the term *risk oversight* to clarify that the board's role is to oversee management, which is responsible for the day-to-day risk management processes.

Directors and Nominees

The final rules require a company (or other proponent soliciting proxies) to disclose, for each director or nominee, the specific experience, qualifications, attributes or skills that qualify that person to serve as a director at the time that the disclosure is made. The disclosure is required annually, even if a director is not up for reelection in a particular year. The final rules, in contrast to the proposed rules, do not specify any particular qualifications (*e.g.*, risk assessment skills) that a director or nominee should possess or that a company should describe in its proxy statement. Rather the rules are intended to give companies flexibility in determining the information relating to their directors that should be disclosed to investors.

The rules as proposed would have also required a company to disclose annually, for each director or nominee, the specific experience or attributes that qualify that person to serve as a committee member. Given that many companies rotate their directors among different committee positions, the SEC opted not to adopt this proposal. However, the SEC noted that if an individual is appointed or nominated as a director because of a particular attribute related to a board committee (*e.g.*, the audit committee),

that fact should be disclosed when discussing the individual's qualifications to be a director.

In addition, the final rules require disclosure of any directorships at other public companies held by a director or nominee at any time during the past five years, rather than just current director positions at other public companies as currently required.

Consistent with the proposed rules, legal proceedings involving executive officers, directors or nominees are now required to be disclosed for the past 10 years rather than for five years as under the current rules. The final rules also expand the list of legal proceedings that require disclosure to include:

- any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;
- any judicial or administrative proceedings 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.

In the proposing release, the SEC had requested comments on whether a company should be required to disclose additional factors that its nominating committee considers in identifying board nominees, such as board diversity. In the final rules, the SEC adopted a requirement that a company disclose:

- whether, and if so how, its nominating committee considers diversity in identifying nominees for director; and

- how any policy relating to consideration of diversity in identifying board nominees, if any, is implemented, as well as how the nominating committee assesses the effectiveness of the policy.

The SEC noted that companies may have varying conceptions of the term diversity — for some, diversity may refer to differences in viewpoint or experience, while for others, it may focus on race, gender or national origin. Consequently, diversity is not defined in the final rules and companies are permitted to define diversity as they deem appropriate.

Compensation Consultants

Consistent with the proposing release, the SEC adopted rules requiring disclosure of potential conflicts with compensation consultants, although the final rules substantially refine the rules proposed in July. The final rules generally require a company to disclose the fees it pays to a compensation consultant (or its affiliates) if, in addition to executive compensation services, the compensation consultant also provides other services to the company (*e.g.*, benefits administration, human resources consulting or actuarial services).

If a company's compensation committee (or board) engages a compensation consultant to provide executive compensation consulting services, and the consultant also provides additional non-executive compensation consulting services to the company for which the consultant (or its affiliate) is paid fees in excess of \$120,000, a company will be required to disclose:

- the aggregate fees for the executive compensation consulting services and the aggregate fees for the additional services;
 - whether the decision to engage the compensation consultant (or its affiliate) for the additional services was made, or recommended, by management; and
 - whether the compensation committee or the board approved the additional services provided by the compensation consultant (or its affiliate).
- If a company's compensation committee (or board) has *not* engaged a compensation consultant, but management has engaged a compensation consultant to provide other services to the company in addition to executive compensation consulting services, and the consultant (or its affiliate) is paid fees in excess of \$120,000 for the additional services, the company will be required to disclose the aggregate fees for the executive compensation consulting services and the aggregate fees for the additional services.
- No fee or related disclosure is required in situations where a company's compensation committee (or board) and management have each engaged separate compensation consultants.
- The final rules include two additional exceptions from this disclosure requirement:
- Consistent with the proposed rules, no disclosure is required if the executive compensation services provided by the compensation consultant are limited to consulting on non-discriminatory broad-based plans generally available to all employees (*e.g.*, 401(k) and health insurance plans) in which executives and directors may participate.
 - No disclosure is required if the executive compensation services provided by the compensation consultant are limited to providing information that either is not customized for a particular company (*e.g.*,

industry surveys) or that is customized based on parameters that are not developed by the consultant, so long as the consultant does not provide advice or recommendations with respect to the information.

The proposed rules included a requirement that a company also disclose the nature and extent of non-executive compensation services provided by the compensation consultant. The SEC noted the potential competitive harm that could be caused by companies being required to disclose confidential and sensitive pricing information. Consequently, the SEC opted not to require a description of the non-executive compensation services.

Equity Awards

The final rules require that the aggregate grant date fair value of stock and option awards, computed in accordance with FASB ASC Topic 718 (the codification of SFAS 123(R)), be reported in the Summary Compensation Table (and corresponding table for directors) included in proxy statements, rather than the dollar amount recognized for financial statement reporting purposes during the fiscal year.

The rules clarify that the value of performance awards reported in the Summary Compensation Table (and corresponding table for directors, as well as the Grants of Plan-Based Awards Table) should be computed based upon the probable outcome of the performance condition(s) as of the grant date, rather than the amount payable for maximum performance. Companies will, however, be required to include a footnote to the table disclosing the maximum value of the performance award assuming the highest level of performance conditions is probable.

Companies will be required to present recomputed disclosure for each prior fiscal year

required to be included in the Summary Compensation Table for the named executive officers included based on the determination of named executive officers for the most recently completed year, so that the stock awards and option awards columns present the applicable full grant date fair values (with performance awards computed as described above), and the total compensation column for those years is correspondingly adjusted. Companies will not be required to include different named executive officers for any prior fiscal year based on recomputing total compensation for those years, or to amend the Summary Compensation Table in prior years' filings.

The SEC had proposed amending the Summary Compensation Table to provide that companies would not be required to report in the salary and bonus columns the amount of salary or bonus forgone at a named executive officer's election, and to provide that non-cash awards received instead would be reportable in the column applicable to the form of award elected. The SEC opted not to adopt this proposal as it felt that disclosing the amounts of salary and bonus that the compensation committee awarded better enables investors to understand the relative weights the company applied to annual incentives and salary.

The SEC had also proposed rescinding the requirement to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table (and corresponding disclosure with respect to directors) in order to avoid duplication of information with the revised Summary Compensation Table (and corresponding table for directors). This proposal was not adopted because the SEC agreed with several comments that investors would be better served by retaining disclosure of the value associated with each type of equity award granted, which would

help investors better evaluate the decisions of the compensation committee.

Shareholder Voting Results

The final rules require a company to disclose on Form 8-K (rather than on Form 10-Q or 10-K) the results of any shareholder vote within four business days after the end of the meeting at which the vote was held. If definitive vote results are not available within that time frame, companies are required to disclose on Form 8-K the preliminary voting results within four business days after such preliminary voting results are determined, and file an amended report on Form 8-K within four business days after the final voting results are certified. To avoid any potential confusion when reporting preliminary voting results, companies may include additional disclosure that helps put preliminary voting disclosure in a proper context.

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