

To: Our Clients and Friends

December 17, 2009

SEC Approves Rule Changes Regarding Executive Compensation and Corporate Governance

Yesterday the SEC approved rule changes that would expand proxy statement disclosures relating to executive compensation and corporate governance. The text of the new rules is available at [New SEC Rules](#).

Additionally, Chairman Shapiro confirmed that the SEC expects to act on the controversial proxy access proposal (which was discussed in our [June 22 Client Bulletin](#)) in early 2010.

The SEC approved the new rules in a 4-1 vote, with the dissenter, Commissioner Casey, objecting to certain elements of the required disclosures of individual director qualifications and board diversity policies, as discussed below.

Consideration of the proposed amendments to the proxy solicitation rules was deferred.

Effective Date

The new rules take effect February 28, 2010. Although not expressly stated, this presumably means that proxy statements filed on or after that date would be subject to the new rules, even if the company's Annual Report on Form 10-K was filed prior to such date.

Compensation Policies and Practices Regarding Risk-Taking

The new rules require a broader discussion of the relationship of compensation policies and practices for employees generally, including non-executive officers, and how such practices relate to risk management practices and risk-taking incentives. In changes from the original proposal:

- *Reasonable Likelihood*. Disclosure is only required to the extent the policies or practices are "reasonably likely to" have a material adverse effect on the company, instead of "may," as proposed. The SEC noted that this standard is the same as used in MD&A. Companies may take

into account compensating or offsetting steps or controls in evaluating whether disclosure is required. Additionally, only “adverse” changes are covered.

- *Not Part of CD&A.* The new disclosure is not part of CD&A to avoid potential confusion since such new disclosure is not limited to NEOs. The SEC noted, however, that CD&A should already discuss risk considerations to the extent material to compensation policies or decisions for NEOs.
- *Smaller Reporting Companies.* The new rules do not apply to “smaller reporting companies.”

The new rules provide illustrative examples of arrangements that may require disclosure, as proposed and set forth in [Exhibit A](#) attached hereto.

Stock and Option Awards

As proposed, the new rules require disclosure of the aggregate grant date value of stock and option awards in the Summary Compensation Table and the Director Compensation Table (in accordance with FASB ASC Topic 718, f/k/a SFAS 123R). By contrast, the current rules require disclosure of the dollar amount recognized for financial reporting purposes. In changes from the original proposal:

- *Performance-Based Awards.* Awards subject to performance conditions would be reported based on the probable outcome of the performance conditions, with their maximum potential value disclosed in a footnote. The SEC recognized that requiring disclosure of the maximum value in the table would overstate the intended compensation and could discourage use of performance-based awards. The probable value should be consistent with the estimate of aggregate compensation cost recognized over the service period under Topic 718, excluding estimated forfeitures.
- *Recomputation of Prior Year Amounts.* Companies with fiscal years ending on or after December 20, 2009 must recompute prior year amounts, but would not need to change the NEOs in those years.

The SEC decided not to make certain other changes that were considered as part of the proposal:

- *Grants During the Last Fiscal Year.* The final rules continue to require disclosure of awards granted during the year, without regard to whether awards after year-end are granted for services in the prior year. The SEC believed that changing this approach could result in inconsistent disclosure practices. However, the SEC believes companies should evaluate whether post-year end awards might be relevant to understand compensation for the last fiscal year in CD&A.
- *Deferral of Salary or Bonus.* The final rules continue to report in the salary or bonus columns amounts foregone at an officer’s election in exchange for a non-cash award. Companies should continue to footnote the receipt of non-cash compensation and refer to the Grants of Plan-Based Awards Table where the award would be reported.

- *Grant Date Fair Value in Other Tables.* The full grant date fair value of equity awards will continue to be reported in the Grant of Plan-Based Awards Table and the Director Compensation Table.

Directors and Nominees

The new rules expand Item 401 of Regulation S-K to require disclosure of additional information regarding directors and nominees:

- *Experience and Qualifications.* As proposed, companies must disclose the specific experience, qualifications, attributes or skills of directors and nominees that led the board to conclude the individual should serve as a director as of the time of filing, whether or not up for election. If material, the disclosure should cover more than five years, including information about particular areas of expertise or other qualifications.
 - No particular information must be covered, with the SEC dropping a proposed requirement to discuss “risk assessment skills.”
 - Companies need not discuss qualifications to serve on particular board committees, unless an individual was chosen because of a particular attribute.

Commissioner Casey’s dissent was based in part on her view that this new requirement is not useful to investors and may misrepresent to investors how directors are selected by unduly focusing on individual (“person-by-person”) characteristics without regard to the board’s overall composition.

- *Other Directorships.* As proposed, the new rules require disclosure of directorships at public companies and registered investment companies held by directors and nominees at any time during the past five years, not just current directorships.
- *Legal Proceedings.* As proposed, the new rules require disclosure of involvement of directors and nominees in certain legal proceedings during the preceding ten years, instead of just the preceding five years. Additionally, the types of covered legal proceedings are expanded 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; and
 - Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Any settlement in the first two bullets is covered, except for a settlement of a civil proceeding among private parties.

Board Diversity

In the original proposal, the SEC had queried whether it should adopt rules regarding board diversity policies. In response to comments, the new rules require disclosure regarding:

- Whether and, if so, how diversity is a factor in considering candidates for nomination to the board of directors; and
- If the board (or nominating committee) has a diversity policy, how it is implemented and how the board assesses its effectiveness.

The new rules do not define “diversity” and instead allow companies to consider different approaches, such as approaches based on backgrounds, perspectives and other factors. While Commissioner Casey supported disclosure of consideration of diversity in nominations, her dissent was based in part on her view that required disclosure regarding implementation and assessment of effectiveness is unduly burdensome and goes beyond mere disclosure.

Board Leadership Structure

As proposed, the new rules require disclosure regarding:

- Whether and why the CEO and Chairman positions are combined or separated;
- Why such structure is the most appropriate one at the time of the filing;
- If such positions are combined, whether and why there is a lead independent director and the specific role he or she plays; and
- The board’s role in oversight of risk, e.g., the full board versus separate risk or audit committees, and the effect on the board’s leadership structure.
 - Whether the individuals who supervise risk management report directly to the board or to a committee, and how such entity receives information from such individuals.
 - In response to comments, the new rules changed the terminology regarding the board’s role from “risk management” to “risk oversight.”

Conflicts of Interest of Compensation Consultants

As proposed, the new rules require increased disclosure of potential conflicts of interests of compensation consultants. However, in response to the comments, the proposals were changed as follows:

- A dollar threshold of \$120,000 was established;
- Disclosure is reduced if the board is advised by its own consultant; and
- The exceptions from disclosure were expanded.

As modified, the new rules provide that, in addition to the existing requirement to describe the role of compensation consultants in determining or recommending the amount of executive officer or director compensation:

- *Consultant Hired by Board.* If the board or compensation committee engaged its own consultant with respect to executive or director compensation, and the consultant or affiliate provided additional (non-executive compensation) services of more than \$120,000 in the last fiscal year, then disclosure would be required, including the aggregate fees paid for both the consulting and additional services.
 - Disclosure would also be required whether the hiring decision was made or recommended by management, and whether the board approved such additional services.
- *No Consultant Hired by Board.* If the board or compensation committee did not engage its own advisor, and management retained a consultant providing executive compensation services for additional (non-executive compensation) services for more than \$120,000 in the last fiscal year, then disclosure would be required regarding the fees paid for both compensation consulting and additional services; no disclosure would be required where the fees paid for additional services are \$120,000 or less during such fiscal year.
- *Effect of Board Consultant.* If the board or compensation committee engages its own executive compensation consultant, then no fee disclosure is required for consultants that work with management, whether for only executive compensation or for both executive compensation and other additional services.
- *Exclusions.* No disclosure is required for services involving only broad based, non-discriminatory plans, such as 401(k) or health insurance plans, or the provision of information, such as surveys, that are not customized for the company or are customized based on parameters not developed by the consultant.
 - The exception would not be available if the consultant provides advice or recommendations in connection with the survey.

If disclosure of fees is required, the new rules do not require disclosure of the nature or extent of additional services provided by the consultant and its affiliates. However, the SEC noted that companies have the discretion to include a description of such services, if desired.

Accelerated Reporting of Voting Results

As proposed, the SEC created a new 8-K item requiring announcement of shareholder voting results within four business days after the shareholder meeting, as follows:

- Disclosure is required within four business days after the end of the meeting in all cases, with the disclosure to reflect preliminary results (the SEC staff cautioned that companies should include supplemental cautionary disclosure, where such preliminary results may change).
- An amended 8-K would be required within four business days after final results are known.

The new 8-K item replaces the corresponding item in the current 10-K and 10-Q rules.

Proposed Changes to Proxy Solicitation Rules

As discussed in our [July 17 Client Bulletin](#), the SEC had proposed a number of changes to the proxy solicitation rules. The SEC staff explained that these were being deferred.

Recommended Actions

In light of the new rules and the beginning of the new proxy season, consideration might be given to the following:

- *D&O Questionnaires*. Update or supplement D&O Questionnaires to address the new disclosure requirements (e.g., experience and qualifications of directors and nominees, other directorships and legal proceedings).
- *Risk Analysis of Compensation Programs*. Review and evaluate compensation policies and practices for all employees, with emphasis on bonus and other incentive compensation plans, not just those adopted for senior management. Consider what types of risks the company believes it should evaluate (operational? EPS? liquidity? credit? compliance? reputation? others?). Consider whether there are particular business units that warrant special focus.
 - Evaluate the extent to which policies and practices incentivize risk-taking or risk management (with particular focus on risk by business unit). Consider the types of metrics used in performance-based compensation, i.e., materiality of effect on company.
 - Evaluate any mitigating programs or policies that might be in place, such as the mix of fixed vs. performance and long-term vs. short-term compensation, as well as bonus caps or claw-back, hold-to-retirement, stock ownership or other policies.
 - Consider any changes to plans or programs over the last fiscal year and rationales in light of the company's risk profile. Consider whether to evaluate upcoming or future incentive compensation awards or compensation programs, and whether any actions should be taken to manage or mitigate risk-taking.
 - Consider coordinating with the audit committee or other body to the extent it is responsible for enterprise risk management.
- *Grant Date Fair Values*. Perform calculations to evaluate the effect on the list of NEOs for the Summary Compensation Table, and recompute prior year amounts.
- *Board Leadership Structure*. Collect information regarding the board's oversight of the risk management process, including reporting responsibilities to the board or committees, and how the board or committees monitor risk management.

- *Nominating and Corporate Governance.*
 - Determine the rationale for the combination (or separation) of chairman and CEO positions, in light of the company's particular characteristics or circumstances. Confirm and/or document the role of any lead independent director.
 - Coordinate with the nominating committee to collect information and prepare proposed disclosures regarding director experience and qualifications.
 - Discuss and evaluate any board diversity policies.
- *Compensation Consultants.* Identify all compensation consultants and affiliates that played a role in determining or recommending the amount or form of executive or director compensation. Determine whether any provided any additional services. If a consultant or any of its affiliates played any such role and provided additional services, then collect required additional disclosures.

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Exhibit A

Examples of CD&A Topics

By way of example, the new rules identify several scenarios in which disclosure of compensation policies and practices may be required:

- At a business unit that represents a significant portion of the company's risk profile;
- At a business unit where compensation is structured significantly differently than other company units;
- At business units that are significantly more profitable than others;
- At business units 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.

If disclosure is required, the new rules identify some of the issues companies may need to address, including:

- 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 and the manner of its implementation;
- The company's risk assessment or incentive considerations in structuring its compensation policies or in awarding and paying compensation;
- How the company's policies relate to the realization of risks resulting from actions of employees in both the short term and 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 providing incentives to employees.