MORRISON | FOERSTER

Legal Updates & News

Legal Updates

SEC Adopts New Compensation and Governance Disclosure Rules

December 2009
by David M. Lynn, Michael T. Frank, Lawrence R. Bard

Related Practices:

- Corporate
- Public Companies & Corporate Governance

On December 16, 2009, the Securities and Exchange Commission (the "SEC") approved rule changes that will mandate more disclosure in proxy and information statements regarding risk, compensation and corporate governance matters.[1] Specifically, the changes will require disclosure concerning:

- The relationship of a company's compensation policies and practices to risk management, when those compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company;

- The grant date fair value of equity awards in the Summary Compensation Table, replacing the prior approach of requiring disclosure of the amounts of compensation expense recognized for financial reporting purposes;

- The potential conflicts of interest that compensation consultants may have when performing services for the company, focusing on disclosure of fees paid (subject to a $120,000 threshold) for executive compensation services and for additional services;

- The background and qualifications of directors and nominees for director, describing the experience and skills that led the company to choose the director or nominee for the board;

- Other public company directorships held by each director or nominee over the past five years;

- Legal proceedings involving a company's executive officers, directors, and nominees for director, including disclosure covering the past ten years and covering a significantly expanded list of relevant proceedings;

- The board of directors' consideration of diversity in the process by which directors are considered for nomination to the board;

- The leadership structure of the board, including whether the company has combined or separated the roles of chairman and principal executive officer, and why the company believes that its leadership structure is appropriate for the company, as well as a discussion, in some circumstances, of whether and why, a company has a lead independent director;

- The extent of the board's role in the oversight of risk; and

- Voting results, which are to be provided on a significantly accelerated basis under cover of Form 8-K.

The SEC had also proposed revisions to the rules governing the proxy solicitation process that were intended to clarify the manner in which soliciting parties communicate with shareholders. However, it decided to consider those rule changes in connection with the proxy access rule proposals.[2]

The new rules will be effective on February 28, 2010. The implementation of these rule changes for the 2010 proxy season will be challenging. Companies will need to understand these rules immediately so that they can make appropriate changes to their D&O questionnaires, disclosure controls and procedures, and other disclosure-related processes so that the appropriate information can be collected and disclosed in upcoming proxy statement filings.

Compensation Disclosure Changes

The Relationship between Overall Compensation and Risk
The SEC adopted a rule that it believes will help investors understand whether a company has incentivized its employees to engage in excessive or inappropriate risk-taking activities. The SEC's rulemaking in this area developed out of the concerns arising from the financial crisis, including legislative efforts that focused on how compensation policies may have created unnecessary or excessive risks at financial institutions.

In a departure from the SEC's historical disclosure approach, this new requirement would elicit disclosure about the compensation policies and practices for *all* employees, not just the executive officers of the company. The disclosure will be limited to compensation policies and practices, however, such that no further disclosure regarding the specific amounts of compensation paid to employees would be required under the new rules.

In response to commenters' concerns that this new disclosure may be confusing if included as part of the Compensation Discussion and Analysis (the "CD&A"), the SEC decided to require the disclosure outside of the CD&A, under a discrete disclosure requirement. Nonetheless, disclosure concerning the relationship between compensation and risk may be required in the CD&A specifically with regard to the named executive officers, consistent with the guidance that the SEC provided in both the proposing and adopting releases for these rule changes, which both stated that"[t]o the extent … such risk considerations are a material aspect of the company's compensation policies or decisions for named executive officers, the company is required to discuss them as part of its CD&A under the current rules."

As adopted, the disclosure will be triggered if compensation policies and practices create risks that are "reasonably likely to have a material adverse effect" on the company.[3] The standard of "reasonably likely to have a material adverse effect" tracks the requirements in Item 303 of Regulation S-K, Management's Discussion and Analysis of Results of Operations and Financial Condition (the "MD&A"). In response to concerns expressed by commenters, the SEC decided to adopt this higher standard relative to the proposed standard, which looked to whether the compensation policies or practices "may have a material effect" on the company. In discussing these changes between the proposed rule and the final rule, the SEC noted that this standard would be more familiar to companies, given that it is applied in determining whether known material trends, demands, events, and uncertainties must be disclosed. Focusing the standard on whether the risk may have a material adverse effect on the company will also permit companies to consider compensation policies and practices that mitigate or balance incentives. Further, the addition of the term "adverse" to the test clarifies that companies do not have to discuss ways in which compensation policies and practices may encourage risk taking that is beneficial to the company.

The final rule includes a non-exclusive list of situations where compensation programs may have the potential to cause material adverse risks for companies. These 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;
- At a business unit 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, 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.

Further, the final rule includes a non-exclusive list of illustrative examples of the types of issues that a company may need to address if it has determined that compensation polices and practices create risks that are reasonably likely to have a material adverse effect on the company. These issues include:

- The general design philosophy of the 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 that affect risk taking by those 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.

The new disclosure regarding the relationship between compensation and risk will not be required for those companies that qualify for scaled disclosure as a "smaller reporting company."

Changes to the Summary Compensation Table and the Director Compensation Table

One of the vexing problems from the 2006 changes to the executive compensation disclosure rules was that the SEC required disclosure in the Summary Compensation Table of the compensation expense associated with equity awards (which included expensed amounts related to awards granted in prior fiscal years), rather than the grant date fair value of the awards made in the subject fiscal year covered in the Summary Compensation Table. This approach created difficulties for companies when presenting their executive compensation disclosure, because the presentation in the Summary Compensation Table of equity award values did not necessarily correspond with decisions that the compensation committee made in the fiscal year covered by the CD&A. In order to address this disconnect, some issuers began including "alternative summary compensation tables" and taking other approaches to try to clarify how the decisions addressed in the CD&A related to the amounts presented for the named executive officers.

The SEC has now adopted changes that will require the disclosure of the grant date fair value of the equity awards made during the fiscal year in the "Option Awards" and "Stock Awards" columns of the Summary Compensation Table and the Director Compensation Table. These numbers will reflect the grant date fair values calculated in accordance with the Financial Accounting Standards Board's Accounting Standards Codification Topic 718 (formerly known as FAS 123R and referred to here as "ASC Topic 718"). For performance-based awards, the SEC will now require reporting of the fair value at the grant date based on the probable outcome of the performance conditions (rather than the maximum potential value of the award), which should be consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under ASC Topic 718. The maximum potential value of the awards will be disclosed in a footnote to the Summary Compensation Table and the Director Compensation Table.

Companies will still be required to report the full grant date fair value of each equity award in the Grants of Plan-Based Awards Table. Performance-based equity awards reported in the Grants of Plan-Based Awards Table will be reported based on the probable outcome of meeting the performance condition, as with the Summary Compensation Table.

The SEC decided not to adopt a proposed change to its rules that would have permitted companies to report salary and bonus foregone at the named executive officer's election in the appropriate column for the award elected. As a result, salary and bonus will continue to be reported in the "Salary" and "Bonus" columns even when foregone at the named executive officer's election, with footnote disclosure indicating receipt of the non-cash compensation and referring to the Grants of Plan-Based Awards Table where the stock, option, or non-equity incentive plan compensation is reported.

In order to transition to the new presentation approach for equity awards and to preserve comparability across the three fiscal years required to be included in the Summary Compensation Table, the SEC will require companies with a fiscal year ending on or after December 20, 2009 to restate the prior two fiscal years included in the Summary Compensation Table to reflect the new approach on equity awards. Companies will not, however, be required to determine if different named executive officers should be reported in the table based on changes to the total compensation that will inevitably arise in shifting from the expensed amounts to the aggregate grant date fair value.

Compensation Consultant Conflicts
The new rules will require disclosure about fees paid to compensation consultants and their affiliates in specified circumstances.

In particular, if the board, compensation committee, or other persons performing an equivalent function (referred to in this section as the "board") has engaged its own compensation consultant to provide advice or recommendations regarding the amount or form of executive and director compensation, and this same consultant or the consultant's affiliates provide other consulting services to the company that do not involve executive compensation in an amount that exceeds $120,000 during the last fiscal year, then the company must disclose:

- The aggregate fees paid for services provided either to the board or the company with regard to determining or recommending the amount or form of executive and director compensation;

- The aggregate fees paid for any non-executive compensation consulting services provided by the consultant or its affiliates; and

- Whether the decision to engage the compensation consultant or its affiliates for the non-executive compensation consulting services was made, or recommended by, management and whether the board approved such other services.

In situations where the board has not engaged its own consultant, then disclosures are required if a consultant is engaged to provide both executive compensation consulting services and non-executive compensation consulting services to the company, provided that the fees for the non-executive compensation consulting services exceed $120,000 during the company's fiscal year. In this situation, disclosure is required of:

- The aggregate fees paid to the consultant or its affiliates for determining or recommending the amount or form of executive and director compensation; and

- The aggregate fees paid for any non-executive compensation consulting services provided by the consultant or its affiliates.

If the board and management have different compensation consultants, then no fee disclosure is required even if management's compensation consultant provides additional services to the company, recognizing that when the board engages its own compensation consultant, it mitigates the risks for the conflicts of interest that the SEC is seeking to address with the additional fee disclosure. Moreover, disclosure is not required when the compensation consultant's only role in recommending the amount or form of executive or director compensation is limited to consulting on broad-based plans that do not discriminate in favor of executive officers or directors of the company. Disclosure is also not required when the compensation consultant's service are limited to providing information, such as surveys, that is not customized for a particular company, or that is customized based on parameters that were not developed by the compensation consultant.

The SEC did not adopt a proposed requirement to disclose the nature and extent of additional services provided by the compensation consultant or its affiliates, given the potentially competitive nature of this information. Companies still may provide some explanation of the types of services provided, if the additional information is necessary to an understanding of a potential conflict of interest.

Corporate Governance Disclosure Changes

Director and Nominee Qualifications

The SEC adopted revisions to Item 401 of Regulation S-K, which sets forth disclosure requirements for the backgrounds of executive officers, directors, and nominees for director, to require disclosure, for each director and any nominee for director, the particular experience, qualifications, attributes, or skills that led the board to conclude that the person should serve as a director of the company, as of the time that the filing is made with the SEC. The disclosure will be required for all nominees for director (including nominees put forward by a proponent other than the company), as well as for all existing directors, even if not subject to re-election at the meeting to which the proxy statement relates. This new director and nominee disclosure requirement will augment, but not replace, specific disclosure currently required regarding the consideration by the nominating committee of minimum director qualifications, or specific qualities or skills.

The new disclosure requirement does not mandate the particular information that must be disclosed. Rather, the SEC indicated that it wanted to provide issuers with flexibility to determine what information concerning a director's or nominee's skills, qualifications, or particular area of expertise should be disclosed to shareholders.

The SEC did not adopt a proposal to require disclosure of the specific experience, qualifications or skills that qualify a director to serve as a member of a particular committee. However, the SEC has noted in the adopting release that if the director or a nominee has been chosen to join the board because of particular expertise that is relevant to a specific committee, then that fact should be disclosed in response to the new disclosure item.

Outside Directorships

The SEC also adopted a new requirement for disclosure regarding other public company directorships held by directors or nominees over the past five years (even if a director is no longer serving as a director of the other public company). This new requirement expands upon already required disclosure regarding current director positions at other companies.

Legal Proceedings

Item 401(f) of Regulation S-K currently requires disclosure regarding a director's, nominee's, or executive officer's involvement in specific legal proceedings that are material to an evaluation of the integrity of such person. The SEC has extended the "look back" provision in Item 401(f) from five years to ten years, and will now require disclosure regarding the following additional legal proceedings:

- 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 of such actions; and
- Any disciplinary sanctions or orders imposed by stock, commodities, or derivatives exchanges or other self-regulatory organizations.

The rules will not require disclosure of a settlement of a civil proceeding among private parties. As is the case before these amendments, the disclosure of specific legal proceedings (including the newly added proceedings specified above) are not required to be disclosed if the proceeding is not material to an evaluation of the ability or integrity of the director or director nominee.

Director Diversity

The new rules will require disclosure of whether, and if so, how, the nominating committee considers diversity in identifying director nominees. Further, if the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, then disclosure will be required of how the policy is implemented and monitored for effectiveness. In adopting this new requirement, the SEC has not defined the term "diversity," leaving it to each company to define diversity in the way that the company deems appropriate.[4]

Board Leadership Structure

The SEC adopted new disclosure requirements regarding board leadership structure that were substantially as proposed. The new disclosure is designed to provide shareholders with more information about the board's leadership structure and the reasons for that structure.

Under the amendments, a company will have to disclose whether and why it has chosen to combine or separate the principal executive officer and board chairman positions, as well as the reasons why the company believes that this board leadership structure is the most appropriate structure for the company at the time of the applicable filing. In those situations where there is a combined principal executive officer and board chairman but also a lead independent director, then the company must disclose whether and why the company has a lead independent director and the specific role that the lead independent director plays in the leadership of the company.

The Board's Oversight of Risk

Consistent with the SEC's focus on risk following the financial crisis, a newly-adopted disclosure requirement will mandate disclosure about the board's involvement in the oversight of the company's risk management process. Companies have flexibility under this disclosure requirement to describe how the oversight role is exercised, i.e. whether it is through the activities of the entire board, a risk committee of the board, or another committee of the board, such as the audit committee. The SEC also indicates that, where relevant, companies may want to address whether the individuals who supervise risk management report to the board or a board committee, or otherwise how the board or the appropriate committee receives information from risk managers.

Accelerated Disclosure of Voting Results

Prior to the SEC's action, voting results from annual or special meetings were required to be disclosed in periodic reports on Form 10-Q or 10-K, which resulted in a significant delay in the time between when the meeting occurred and when shareholders learned of the results from their voting decisions. The SEC has now moved the requirement for disclosure of voting results from Forms 10-Q and 10-K to Form 8-K. Now, voting results will need to be filed under Item 5.07 of Form 8-K within four business days after the end of the meeting at which the vote was held.

In order to accommodate situations where it may be difficult to determine final voting results within the four day filing window, the SEC has provided an Instruction to Item 5.07 which indicates that a company is required to file preliminary voting results within four days after the end of the shareholders' meeting, and then file an amended Form 8-K within four business days after the final voting results are known. If definitive voting results are obtained within the initial four day filing window, then those definitive results may be filed and no preliminary results need be filed.

What to Do Now

Given that the new rules will apply to many filings that are anticipated to be made this proxy season, companies must quickly respond to the anticipated changes brought about by the SEC rules. Initial steps should include:

- Revise your D&O Questionnaire to capture more information about directors, nominees, and executive officers for longer timeframes;

- Specifically highlight the D&O Questionnaire changes to directors and executive officers so that they can focus on the additional information that is now required;

- Revise your disclosure controls and procedures to ensure that information required by the new rules is recorded, processed, summarized, and reported in a timely manner;

- Consider whether any changes should be made to the board's leadership structure, risk oversight, diversity policy or the use of compensation consultants by the company and the board, all in light of not only the new disclosure requirements, but also given the underlying shareholder concerns and the policies of applicable proxy advisory firms;

- Carefully consider how the new information regarding director qualifications will be developed and presented in the proxy statement, given the significance of this disclosure in the context of an ever-rising level of shareholder activism that often targets specific directors for withhold/against vote campaigns; and

- If it does not already exist, develop a process to evaluate the relationship of compensation and risk for the entire organization, as well as specifically for the named executive officers. The steps in this process might include:

    - Create an "inventory" of known risks, which may go beyond the risks listed in the "Risk Factors" section of the company's periodic reports;

    - Identify and evaluate compensation policies and practices within the organization, and determine how those compensation policies and practices relate to specific risks;

    - Determine if the risks are reasonably likely to have a material adverse effect on the company; and

    - Develop the disclosure to be included in the proxy statement, including appropriate disclosure for those situations where it is concluded that risks related to compensation are not reasonably likely to have a material adverse effect on the company.

The 2010 proxy season promises to be tumultuous, particularly given the changes to New York Stock Exchange Rule 452 that prohibit discretionary voting by brokers in the election of directors. Shareholders and proxy advisory services will likely focus on these new SEC-mandated disclosures when making their voting decisions and voting recommendations on the election of directors. In addition to ensuring compliance with the new rules, companies will want to work to make their proxy statement disclosures as clear and understandable as possible, focusing in particular on the governance and executive compensation considerations that are of most interest to shareholders and the SEC.

Footnotes

[1]Release No. 33-9089 (December 16, 2009).

[2] See our Legal Update entitled "SEC Issues Proposing Release for Rules to Permit Shareholder Access to a Company's Proxy Statement for Director Nominations**.**"

[3] The rules do not require a company to make an affirmative statement that it has determined that risks arising from compensation policies and practices are not reasonably likely to have a material adverse effect on the company, although companies may need to consider whether to add such a statement, as well as an explanation of the company's process for evaluating risks arising from compensation policies and practices, in order to

address the inevitable concerns of shareholders and proxy advisors.

[4] The SEC notes that some companies may define diversity to include “differences of viewpoint, professional experience, education, skill and other qualities or attributes that contribute to board heterogeneity,” while other companies may define diversity to include race, gender and national origin.