Securities Law Advisory: SEC Finalizes Enhanced Compensation and Corporate Governance Disclosure Requirements

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In a release issued on December 16, 2009, the Securities and Exchange Commission (the SEC) finalized several amendments to its executive compensation and corporate governance disclosure requirements in Regulation S-K.[1] These changes are intended to improve several aspects of the disclosures provided to shareholders of public companies, and primarily concern the areas of **risk, governance and director qualifications,** and **compensation,** as follows:

- **Risk:** the rules require disclosure on compensation policies and practices that are reasonably likely to have a material adverse effect on a company, and disclosure of the role of the board of directors in management and oversight of the risks facing a company.
- **Governance and Director Qualifications:** the rules require additional disclosure about the background and qualifications of directors and director nominees, as well as disclosure about a board's leadership structure and the rationale for choosing that structure.
- **Compensation:** the rules revise the summary compensation and the director compensation tables in which annual stock and option awards issued to named executive officers and directors are reported, in order to reflect the grant date fair value of such awards, rather than the dollar amount recognized for financial statement purposes, for a particular year. The rules also require disclosure about the fees paid to compensation consultants and their affiliates when they take part in determining or recommending the amount or form of executive or director compensation.

The rules also move the requirement to disclose results of voting at shareholder meetings to Form 8-K from Forms 10-Q and 10-K, which will require results to be reported within four business days of a shareholder meeting. The rule amendments are discussed in greater detail below.

New Narrative Disclosure of Compensation Practices and Policies Relating to Risk Management

New Item 402(s) of Regulation S-K requires a company to describe its compensation policies and practices for *all* of its employees, including non-executive officers, if those compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. In response to comments on the proposed rules, the SEC changed the standard that would trigger disclosure from policies and practices that "may have a material effect on the company" to those that "are reasonably likely to have a material *adverse* effect on the company" [emphasis added]. The SEC intends the "reasonably likely" disclosure threshold for this purpose to be the same as that which is applied in the MD&A context, requiring risk-oriented disclosure of known material trends and uncertainties relating to the company as a whole. Another change from the proposed rules is that this disclosure will not be required within the Compensation Discussion & Analysis (CD&A) section, but rather will form a separate narrative under the general compensation disclosure section of a company's proxy statement (or in the Part III section of an Annual Report on Form 10-K).[2]

The SEC notes that these changes are intended to address the concern that the structure and application of incentive compensation policies have created, in certain situations, inadvertent incentives for management and non-executive employees that may lead to decisions that significantly increase the company's risk and are inconsistent with the overall best interests of the company. For example, many believe that the short-term incentives created by the compensation structures in financial institutions encouraged disproportionate risk-taking, and contributed in some part to the global financial crisis that began in late 2008.

Item 402(s) contains a non-exclusive list of the following compensation policies and practices that may trigger disclosure:

- at a business unit that carries a significant portion of the company's risk profile
- at a business unit with compensation structured significantly differently from the other units within the company
- at a business unit that is significantly more profitable than others within the company
- at a business unit where compensation expenses are a significant percentage of the unit's revenues
- 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.

If a company concludes that it does have compensation policies or practices that create risks that are reasonably likely to have a material adverse effect on the company, the SEC has provided a non-exclusive list of issues that the company may need to address regarding its compensation policies or practices:

- 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 those policies relate to or 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 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 (for example, policies requiring clawbacks or imposing holding periods)
- the company's policies regarding adjustments to its compensation policies to address changes in its risk profile, and any material adjustments made as a result of those policies
- the extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

If a company concludes that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company, the rule does not require it to make an affirmative statement to that effect. This disclosure is not required to be provided by smaller reporting companies.

Revisions to Equity Award Disclosure in Summary Compensation Table and Director Compensation Table

The SEC has revised the disclosure tables set forth in the Summary Compensation Table and the Director Compensation Table regarding stock awards and option awards to require disclosure of the *aggregate grant date fair value* of these awards in the year of grant. The fair value amount to be reported in the table would be computed in accordance with FASB ASC Topic 718 ("Stock Compensation;" formerly FASB Statement 123R). This disclosure replaces the current requirement to disclose the *dollar amount recognized for financial statement reporting purposes* for the fiscal year of these awards.

The SEC has made this change in response to investor concerns with the current Summary Compensation Table disclosure, and the belief that aggregate grant date fair value disclosure better reflects compensation committee decisions with regard to equity compensation grants. In addition, to facilitate year-to-year comparisons, this disclosure will be required to present recomputed disclosure for each preceding fiscal year required to be included in the table, so that the stock awards and option awards columns present the applicable full grant date fair values, and the total compensation column will also correspondingly be recomputed. The stock awards and option awards columns should be recomputed based on the individual award grant date fair values reported in the applicable year's Grant of Plan-Based Awards Table, except that awards with performance conditions should be recomputed to report grant date fair value based on the probable outcome of the grant date, consistent with FASB ASC Topic 718, as further discussed below. In addition, if a person who would be a named executive officer for the most recent fiscal year (2009) also was disclosed as a named executive officer two years ago (2007) but not last year (2008), the named executive officer's compensation for all three fiscal years must be reported pursuant to the amendments. However, companies are NOT required to include different named executive officers for any preceding fiscal year based on the recomputed total compensation amounts, or to amend any prior years' Item 402 disclosure in any other filing. For smaller reporting companies that are only required to disclose the two most recent fiscal years, 2008 disclosure is not required to be added for an individual who first appears in the summary compensation table in 2009.

The SEC has also clarified that the grant date fair value disclosure relates to awards that are granted during an applicable fiscal year, as opposed to grants that are made for services rendered during the fiscal year, but where the awards are granted after the fiscal year has ended. However, the SEC also noted that companies should disclose such post-fiscal-year-end grants in their CD&A narratives, and should consider whether tabular disclosure of such awards should be included as a supplemental matter, particularly where the information would help in an understanding of the disclosure in their CD&As.

With respect to awards that are tied to a particular measure of performance (referred to as "performance awards"), the value of such awards must be computed based upon the probable outcome of the performance conditions as of the grant date. The SEC notes that such value "better reflects how compensation committees take performance-contingent vesting conditions into account in granting such awards." This amount will be consistent with the company's estimate of the compensation cost on the grant date to be recognized over the service period, excluding the effect of forfeitures. Companies will also be required to provide footnote disclosure in the Summary Compensation Table and the Director Compensation Table of the maximum potential value of a performance award, assuming that the highest level of performance associated with the award is probable.

The SEC changed its position from the proposing release with respect to the current requirements regarding reporting of the full grant date fair value of each equity award and decided not to rescind the requirement to report these amounts in the Grant of Plan-Based Awards Table and the Director Compensation Table. Therefore, these tables will continue to contain the same grant date fair value disclosures consistent with the prior rules, other than with respect to the change in computation for performance grants to align the disclosure requirement with current accounting rules.

Enhanced Director and Nominee Disclosure

The SEC has revised Item 401 of Regulation S-K to require disclosure of the particular experience, qualifications, attributes or skills that led a company's board to conclude that each director and director nominee should serve as a director of the company, as of the time that the proxy statement is filed with the SEC. This disclosure will be required for all nominees and all directors, even those who are not standing for reelection at a particular meeting. Companies are not required to disclose specific experience, qualifications or skills for individual directors relating to *committee* service. However, if particular skills or attributes that are relevant to service on a specific committee form the basis for the reason that an individual was selected to serve on the board, then those skills or attributes should be identified in the disclosure.

This new disclosure requirement does not specify the particular information that should be disclosed about a nominee or director, and thus companies are free to describe their directors' and nominees' qualifications in any manner that they believe is responsive.

In addition, the SEC has expanded the disclosure that is required concerning directors' and nominees' other directorships of public companies. Instead of solely describing public company directorships held at the time of filing of the proxy statement, as had been the case under the prior rules, companies must now disclose any public company directorships held by their directors and nominees during the *five years preceding* the date of the filing, even if the director or nominee no longer serves on a particular board.

The SEC has also expanded the disclosure required regarding specified legal proceedings. Previously, directors, nominees, and executive officers were required by Item 401(f) of Regulation S-K to disclose legal proceedings in which they had been involved during the past five years. This disclosure has been expanded to capture legal proceedings occurring during the past 10 years. Additionally, the kinds of legal proceedings requiring disclosure have been expanded to include proceedings involving mail fraud, wire fraud or fraud involving any business entity; proceedings based on violations of securities, commodities, banking or insurance laws; and sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Lastly, in response to comments requesting the SEC to require expanded disclosure about board diversity, the SEC has adopted an amendment to Item 407(c) of Regulation S-K to require disclosure of whether, and if so how, a board's nominating committee considers issues of diversity in identifying nominees for director. The SEC deliberately did not define "diversity" for these purposes, noting that "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," and that "for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate." If a nominating committee does have a policy with respect to consideration of diversity in identifying director nominees, the company must disclose how the policy is implemented and how the committee, or the full board, assesses the effectiveness of the policy.

New Disclosure about Board Leadership Structure and the Board's Role in Risk Oversight

The SEC has also adopted amendments that will require companies to provide additional disclosure about the leadership structure of their boards of directors, and the role of their boards in the risk management process.

The SEC has revised Item 407 of Regulation S-K, and adopted a corresponding amendment to Item 7 of Schedule 14A, to require companies to explain why they believe that the board leadership structure they have chosen is the most appropriate structure as of the time of filing the disclosure. Companies are also required to disclose whether and why they have chosen to combine or separate the principal executive officer and board chair positions. Companies that have a single person serving as both principal executive officer and chairman of the board will be required to disclose whether and why they have a lead independent director, and describe the specific role played by the lead independent director in the leadership of the company. The additional disclosure is intended to provide investors with insights about why a company has chosen a particular leadership structure, and is also intended to increase transparency into how boards function.

Second, the SEC has adopted amendments that will require companies to provide additional disclosure about the board's role in a company's risk management process. The intended purpose of the additional disclosure is to provide investors with information about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company. A key insight that may be provided by the disclosure is whether the board implements and manages its risk function through the board as a whole or through an audit committee or other standing committee, and whether and how the board or committee monitors risk.

New Disclosure Regarding Compensation Consultants

Companies often engage compensation consultants to make recommendations on the appropriate levels of executive compensation, to design and implement incentive plans and policies, and to provide information on industry compensation practices. However, compensation consultants and their affiliates also provide additional services, such as benefits administration, human resources consulting, and actuarial services. Because the fees generated by these additional services may be greater than the fees for the executive compensation services, the SEC has raised a concern of a potential conflict of interest that may call into question the objectivity of the consultants' executive pay recommendations. For example, in the SEC's view, compensation consultants may face incentives to cater to management preferences in recommending executive compensation packages so that they may retain an engagement for additional services, providing larger fees. Investors have also raised similar concerns, arguing that the executive compensation services provided by compensation consultants may be influenced by the provision of additional services.

Prior to the revisions, Item 407 required companies to disclose the identity of a compensation consultant, indicate whether the consultant was engaged directly by the compensation committee of a board or by any other person, and disclose the nature and scope of the consultant's assignment, and the material elements of the instructions or directions given to the consultant with respect to the performance of their duties. However, Item 407 did not previously require companies to disclose the fees paid to compensation consultants and their affiliates for executive compensation consulting or additional services. In order to address the concern for the potential conflict of interest in this area, the SEC has amended Item 407 to require disclosure, under specified circumstances, about the fees paid to compensation consultants and their affiliates when they take part in determining or recommending the amount or form of executive or director compensation and also provide additional services to the company, such as benefits administration, human resources consulting or actuarial services.

Under these rules:

- If a company's board or compensation committee has engaged its own compensation consultant to advise the board on the amount or form of executive and director compensation, and the consultant provides other consulting services to the company that are not related to executive compensation in an amount exceeding $120,000 during the company's last completed fiscal year, the company must disclose the aggregate fees paid both for the compensation-related services and the non-compensation-related services. The company would also have to disclose whether the decision to engage the compensation consultant or its affiliates for the non-compensation-related consulting services was made or recommended by the company's management, and whether the board has approved the non-executive compensation consulting services.

- If the company's board has not engaged its own compensation consultant, the company would still be required to disclose the aggregate fees paid to a consultant if the consultant provides both compensation-related and non-compensation-related consulting services to the company, if the fees for the non-compensation-related services exceed $120,000 during the company's last completed fiscal year.
- A company will not be required to disclose fees for compensation consultants that work with management, whether the services provided are compensation-related or non-compensation-related or both, if the board has retained its own compensation consultant that advises it on executive compensation issues.

The new rule does not require disclosure of the nature of the non-compensation-related services that are provided to a company by a compensation consultant. However, companies are free to provide such information if it would be helpful to investors in understanding the disclosure.

The new disclosure will not be required where the compensation consultant's only additional roles are to consult on broad-based plans that do not discriminate, in scope, terms or operation, in favor of executive officers and directors, and that are generally available to all employees, such as 401(k) plans or certain health insurance plans; or to provide information that is not customized for the company or that is customized based on criteria that were not provided by the consultant.

The additional disclosure is intended to enable investors to assess any incentives a compensation consultant may have in recommending executive and director compensation and to better assess the compensation decisions made by the board. The new disclosure requirements are also intended to provide greater transparency in companies' relationships with compensation consultants and alert investors to potential conflicts of interest in this area.

Reporting of Shareholder Voting Results on Form 8-K

Under the new rules, companies will be required to disclose the results of voting at shareholder meetings in Form 8-Ks, rather than in Form 10-Qs and 10-Ks. The rules add a new Item 5.07 to Form 8-K, which requires companies to disclose results of a shareholder vote within four business days after the end of the meeting at which the vote was held.

The change is intended to provide investors with more timely information about the results of voting at meetings, as technological advances in shareholder communications and the use of third-party proxy services have increased the ability of companies to tabulate and disseminate vote results on a more expedited basis. The SEC recognized in the new rules that it may not be possible in all situations for companies to tabulate final voting results within the four-business-day window provided by the Form 8-K. Accordingly, the requirement is to report preliminary results of the votes within four business days, and to file an amended report on Form 8-K within four business days after the final results are known. However, if the final results are known within four business days after the end of the meeting, the final results should be reported on the original Form 8-K.

Timing for New Disclosure Requirements

On December 22, 2009, the SEC issued guidance with regard to the transition to these new rules, which are effective on February 28, 2010.[3] As noted in the interpretive guidance:

1. **Companies with fiscal years ending on or after December 20, 2009** will have to include disclosure that complies with the new requirements in their 2009 Form 10-K and proxy statements if those documents are filed on or after February 28, 2010. If a company plans 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 comply with the new requirements, even if it is filed before February 28, 2010. If the 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 comply with the new requirements.
2. **Companies with fiscal years ending before December 20, 2009** will not have to include disclosure that complies with the new requirements in their 2009 Form 10-K and proxy statements, even if those documents are filed on or after February 28, 2010. In addition, these companies will not have to comply with the new requirements in any registration statements filed before their 2010 Form 10-K.
3. Reporting of the results of annual meetings under Item 5.07 of Form 8-K will take effect for any shareholder meeting that occurs on or after February 28, 2010, even if the proxy statement for that meeting was mailed out before that date. However, if the meeting takes place before February 28, 2010, a Form 8-K will not be required.

Steps to Consider Now

In response to these new rules, management and directors of public companies should consider the following questions, with a view to the disclosure that would flow from each answer, as companies prepare for the annual reporting season for fiscal 2009.

Compensation Committee:

- Consider whether the company's compensation policies and practices for *all* of the company's employees, including non-executive officers, create risks that are reasonably likely to have a material adverse effect on the company:
  - Are there business units that carry a significant portion of the company's risk profile?
  - Are there business units with compensation structured significantly differently from the other units within the company?
  - Are there business units that are significantly more profitable or risky than others within the company?

  - Are there business units where compensation expenses are a significant percentage of the unit's overall expenses?
  - Does the company have compensation policies or practices that vary significantly from the overall risk and reward structure of the company and are not in alignment with the timing of the outcome on which the award was based?
- Is the company using a compensation consultant for which disclosure would be required under the new rules?

Nominating Committee:

- Consider, for each director and nominee, the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director for the company and how the directors' skills and background enable them to function well together as a board, as of the time that a filing containing this disclosure will be made with the SEC. Review the company's current requirements regarding minimum qualifications to serve as a director that are currently set forth in the company's proxy statement to make sure that the new disclosure works with the current nominating committee policy.
- Consider whether, and if so how, the nominating committee considers diversity in assessing director nominees. Consider whether to adopt a policy regarding the consideration of diversity in identifying nominees, how to implement the policy and how to assess its effectiveness.
- Consider the current governing structure of the Board. Is it still appropriate for the company? Are revisions necessary or appropriate?
- Revise the nominating committee charter, if necessary, based on the issues discussed above.

Full Board:

- Consider the board's role in managing and overseeing the material risks facing a company. Has this role been effectively managed by the board? Should the role be delegated to a committee?

Management:

- Update the company's director and officer questionnaire to elicit additional information from directors regarding legal proceedings, public company directorships and other information that the company believes is necessary to gather the information regarding the increased disclosure that is required under the new rules.
- Ensure disclosure controls and procedures are updated to reflect the change in reporting of stockholder meeting results from Forms 10-Q and 10-K to Form 8-K (within four business days of the end of the meeting).
- Is the company using a compensation consultant for which disclosure would be required under the new rules?
- Update disclosure controls and procedures to ensure that the reporting of stock and option awards reflects the aggregate grant date fair value as calculated in accordance with FASB ASC 718.

Endnotes

[1] *See* SEC Release No. 33–9089; 34–61175; IC–29092; File No. S7–13–09, December 16, 2009, available at http://www.sec.gov/rules/final/2009/33-9089.pdf.

[2] Note that the SEC stated in the release that under the current CD&A disclosure rules, to the extent that risk considerations are a material aspect of the company's compensation policies or decisions for its named executive officers, the company is required to discuss them as part of the CD&A and will continue to be required to discuss them in the CD&A after the adoption of these amendments.

[3] This interpretive guidance is available here: http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm.

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