Milbank

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Corporate Governance Group Client Alert

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SEC ADOPTS NEW RULES MANDATING ENHANCED PROXY STATEMENT COMPENSATION AND CORPORATE GOVERNANCE DISCLOSURES

Background

In a release published on December 16, 2009 (the "*Release*")[1], the Securities and Exchange Commission (the "*SEC*") announced new federal proxy rules "designed to improve the disclosure shareholders of public companies receive regarding compensation and corporate governance." The SEC believes that such disclosures will "better enable shareholders to evaluate the leadership of public companies." The new rules, which will be effective for annual reports on Form 10-K and proxy statements filed on or after February 28, 2010 and were by and large adopted as proposed in July 2009, are summarized below.[2] In addition, we have included a chart at the end of this Client Alert setting forth the specific SEC rules in which the new disclosure requirements appear.

Specifically, the new rules are intended by the SEC to "significantly improve the information companies provide to shareholders" regarding risk, governance and director qualifications and compensation. The new disclosure requirements are rooted in three themes often repeated in the Release: (1) enhanced transparency, (2) assessment and oversight of risk and (3) boosting investor confidence.

It should be noted that the proxy rule amendments proposed in July 2009 came on the heels of another, and more controversial, SEC rule proposal to grant

[1] *See* Release No. 33-9089 entitled "Proxy Disclosure Enhancements", which is available on the SEC website at http://www.sec.gov/rules/final/2009/33-9089.pdf.

[2] For a discussion of the proposed rules, *see* our Client Alert entitled "SEC Proposes New Rules for Enhanced Proxy Statement Compensation and Corporate Governance Disclosures" (dated July 27, 2009).

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shareholders access to company proxy statements for the purpose of nominating director candidates.[3] The SEC recently announced that it is extending the comment period on the proposed proxy access rule to permit further comments and analysis, which would indicate that this rule likely will not be in place for the 2010 proxy season.[4]

Disclosure of Compensation Policies Impacting Risk

According to the Release, the SEC believes that investors should be provided "with a better understanding of a company's compensation policies and how such policies can create incentives that could affect the company's risk profile and ability to manage that risk." Consistent with that view, the new rules require that annual proxy statements address "compensation policies and practices for all employees, including non-executive officers, if the compensation policies and practices create risks that are *reasonably* likely to have a *material adverse* effect on the company" (emphasis added).

Significantly, in response to comments received on the proposed rules, the new disclosure rules have not been made a part of the annual proxy statement's Compensation Discussion & Analysis ("*CD&A*"), as originally proposed, because "it would be potentially confusing to expand the CD&A beyond the named executive officers to include disclosure of the company's broader compensation policies and practices for employees." Instead, the new requirements will appear in a separate section in Item 402 of Regulation S-K.

It should also be noted that in its proposing release, the SEC requested comment regarding whether a company should be required to make an affirmative statement, if it has concluded that no disclosure is required, that the company has determined that the risks arising from its compensation policies are not reasonably expected to have a material effect on the company. After noting that the comments received were "mixed," the SEC determined *not* to require such an affirmative statement in the final rule.

The new rule provides examples of issues that a company may need to address in connection with the new disclosure requirements, such as:

- The "general design philosophy" of compensation policies that relate to or affect risk taking by employees;
- The "risk assessment or incentive considerations, if any," used in structuring compensation policies or in making compensation decisions;
- The relationship between compensation policies and the long-term and short-term realization of risks resulting from the actions of employees (such as through claw-back policies or holding periods);

[3] *See* our Client Alert entitled "SEC Proposes Long-Awaited Proxy Access Rules" (dated June 22, 2009).
[4] *See* Release No. 33-9086 entitled "Facilitating Shareholder Director Nominations", which is available on the SEC website at http://sec.gov/rules/proposed/2009/33-9086.pdf.

- Any policies relating to adjustments of compensation policies to address changes in risk profiles and any material adjustments made to compensation policies or practices due to changes in risk profiles; and

- The extent to which compensation policies are monitored to determine whether "risk management objectives are being met with respect to incentivizing … employees."

The new rule also sets forth a *non-exclusive* list of examples of situations that could have the potential to raise material risks to the company and thus trigger enhanced disclosure, including compensation policies and practices:

- At a business unit that carries a significant portion of the company's risk profile;

- At a business unit with compensation structured differently from that of other units within the company;

- At a business unit that is significantly more profitable than others within the company;

- At a business unit whose 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 although the income and risk to the company from the task extend over a significantly longer period of time.

The Release notes that there may be instances where a company concludes that policies and practices set forth on the non-exclusive list do not create risks that are reasonably likely to have a material adverse effect on the company and thus do not need to be disclosed. Similarly, there may be policies or practices not included on the list that could have such an effect and therefore must be disclosed.

Reporting of Equity Awards

The new rules also revise the manner in which stock and option awards are required to be disclosed in the Summary Compensation Table ("*SCT*") and Director Compensation Table ("*DCT*") of the annual proxy statement. Specifically, the new rules amend Item 402 of Regulation S-K to require disclosure of the *aggregate grant date fair value* of awards computed in accordance with FASB ASC Topic 718, which in the SEC's view "better reflects the compensation committee's decision with regard to stock and option awards." Currently, such awards are reported on the basis of the financial statement impact only for the year in question. In response to concerns that particularly large, one-off awards could impact the executive officers required to be identified on the SCT and DCT in any given year, the Release states that if a large "new hire" or "retention" grant results in the omission of "another executive officer whose compensation otherwise would have been subject to reporting, the company can consider including compensation disclosure for that executive officer to supplement the required disclosures."

In response to other concerns that reported amounts might be artificially high, the new rules provide that the value of performance awards reported in these tables "should be computed based upon the probable outcome of the performance condition(s) as of the grant date because that value better reflects how compensation committees take performance-contingent vesting conditions into account in granting such awards." However, the new rules nevertheless also require footnote disclosures in the SCT and DCT of the maximum value of each award assuming the *highest* level of performance conditions.

In order to facilitate year-to-year compatibility, the new rules require a company providing disclosure for a fiscal year ending on or after December 20, 2009 to present recomputed disclosure for each preceding fiscal year required to be included in the tables (as though the new rule had been in effect for those prior years). Also, if a person who is a named executive officer for the 2009 fiscal year was disclosed as such for 2007, but not for 2008, such named executive officer's compensation for *each* of the three fiscal years must nevertheless be reported under the new rules. On the other hand, companies will not be required to include executive officers in the tables who, based on such recomputation, would have been required to be included had the new rules been in effect in a prior period.

Enhanced Director and Nominee Disclosures

In order to "provide investors with more meaningful disclosure that will help them in their voting decisions by better enabling them to determine whether and why a director or nominee is an appropriate choice for a particular company," the final rules amend Item 401 of Regulation S-K to mandate annual disclosure of:

- The "particular experience, qualifications, attributes or skills"[5] possessed by each director (including those *not* up for re-election) and board nominee that led the board to determine that the person should serve as a director[6];

- Any directorships held at public companies and registered investment companies by each director and board nominee at any time during the *previous five years* (as opposed to the current requirement to list only *current* directorships); and

- Any relevant legal proceedings occurring in the previous *ten* years (as opposed to the current requirement to focus only on the previous *five* years).

The list of legal proceedings required to be disclosed has been expanded to include: (i) judicial or administrative proceedings involving mail, wire or other fraud in connection with any business entity; (ii) judicial or administrative proceedings involving securities, commodities, banking or insurance laws and

[5] The reference to "risk assessment skills" that was included in the proposed amendments was deleted, but "if particular skills, such as risk assessment or financial reporting expertise … led the board or proponent to conclude that the person should serve as a director, this should be disclosed."

[6] The final rules do not require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a committee member; however, the Release notes that if a person is chosen because of a particular qualification, attribute or experience related to service on a particular committee, then this should be disclosed.

regulations; and (iii) disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Finally, Item 407(c) of Regulation S-K has been amended "to require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director," as well as disclosure regarding the implementation and assessment of any policy that the board or nominating committee has in place for the "consideration of diversity in identifying director nominees." Because the SEC believes that a company should be permitted to define diversity in ways it sees fit, "diversity" is not defined. According to the Release, "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."

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

As amended, Item 407 of Regulation S-K also requires disclosure of whether a company has combined or separated the principal executive officer and board chair positions, together with the reasons why the company believes its structure is the most appropriate for the company at the time of the filing. Where the positions are combined, the company also must disclose whether and why it has a lead independent director and such director's role in board leadership. The Release states that the additional disclosures of a company's board leadership structure are intended "to provide investors with more transparency about the company's corporate governance, but are not intended to influence a company's decision regarding its board leadership structure."

The amended rule also requires disclosure about the board's role in the oversight of risk – a "key competence" of the board – including "credit risk, liquidity risk, and operational risk." Where "relevant," such disclosure should "address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals."

New Disclosure Regarding Compensation Consultants

Currently, companies are required to include in their annual proxy statements a description of any role played by compensation consultants in determining or recommending the amount or form of executive and director compensation ("*compensation related services*"), the identity of such consultants and a statement as to whether they are engaged directly by the compensation committee or any other person.

The Release notes that compensation consultants (or their affiliates) often provide additional services unrelated to their compensation related services, such as benefits administration, human resources consulting and actuarial services ("*non-compensation related services*"). In the SEC's view, this creates "the risk of a conflict of interest that may call into question the objectivity of the consultant's advice and recommendations on executive compensation" where the fees for non-compensation related services are more significant than the fees for compensation related services.

To address this concern, Item 407 of Regulation S-K has been amended to require the following additional disclosures when compensation consultants provide *both* compensation related and non-compensation related services to the company:

- If the board or compensation committee engages its own consultant to advise on compensation related services and the board's consultant (or its affiliates) also provides non-compensation related services to the company which generated fees exceeding $120,000 during the company's fiscal year, disclosure is required (i) of the aggregate fees paid *both* for (x) the compensation related services and (y) any non-compensation related services, and (ii) whether the decision to hire the compensation consultant (or its affiliates) for non-compensation related services was made or recommended by management and whether the board approved such services; and

- If the board has not hired its own compensation consultant but management has, fee disclosures for all services are required if the fees for the non-compensation related services exceed $120,000 during the company's fiscal year.

In this regard, it should be noted that:

- Fee disclosures for compensation consultants retained by management are *not* required if the board has retained its own compensation consultant;

- Services involving only broad-based non-discriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant, are *not* treated as compensation related services; and

- Disclosure is not required regarding the nature and extent of the non-compensation related services provided by the compensation consultant (and its affiliates) to the company, as was originally proposed (beyond the aggregate fee disclosures described above).

Reporting of Shareholder Voting Results on Form 8-K

Reflecting the SEC's concern with the usefulness of potentially stale information, the new rules require disclosure of the results of votes taken at any annual or special meeting of shareholders held on or after February 28, 2010[7] on a Form 8-K. The Form 8-K must be filed within four business days, with the date of the meeting counting as the first day for this purpose. Currently, such results do not have to be disclosed until the next regularly filed Form 10-Q or 10-K. The new rules also provide that if voting results have not been definitely determined by the required Form 8-K filing date (as often happens in a proxy contest), the preliminary results would be required to be reported on the Form 8-K, with an amendment to disclose the final results within four business days following their certification.

[7] The new rule also provides that corresponding information must be filed in respect of any matter submitted to a vote of shareholders otherwise than at a meeting.

Where to Find Revised and New Rules

New Disclosure Requirements	SEC Rule
Disclosure of Compensation Policies Impacting Risk	Reg. S-K Item 402(s)
Reporting of Equity Awards	Reg. S-K Item 402(c)(2)(v), (vi) and (ix)(G) 402(d) 402(k)(2)(iii), (iv) and (vii)(I) 402(n)(2)(v), (vi) and (ix)(G) 402(r)(2)(iii), (iv) and (vii)(I)
Enhanced Director and Nominee Disclosures	Reg. S-K Item 401(e)(1) and (2) 401(f)(4),(5),(6),(7) and (8) 407(c)(2)(vi)
Disclosure of the Board's Leadership Structure and Role in Risk Oversight	Reg. S-K Item 407(c)(2)(vi) 407(h) Schedule 14A Item 7
New Disclosure Regarding Compensation Consultants	Reg. S-K Item 407(e)(3)(iii)(A) and (B)
Reporting of Shareholder Voting Results on Form 8-K	Form 8-K Item 5.07

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