



# Directors' Duties under the New SEC Rules on Disclosure Enhancement

by William M. Kelly and Mutya Fonte Harsch

New SEC rules require public companies to provide greater disclosure about compensation risks and fees paid to consultants, risk oversight, and directors' experience and qualifications. They also change the way stock and option awards are reported in corporate proxies and demand faster reporting of shareholder votes.

This report discusses the details of the reform and touches on its implications for boards of directors. It also offers sample language and tips for preparation of public filings.

On December 16, 2009, the U.S. Securities and Exchange Commission (SEC) approved final rules relating to key risk, corporate governance, and compensation matters.<sup>1</sup> The new rules, which are effective as of February 28, 2010 for most companies whose fiscal years ended on or after December 20, 2009,<sup>2</sup> address a miscellany of much-discussed issues:

- the relationship between compensation and risk;
- the role of boards in overseeing risk management;
- the qualifications and skills of directors and nominees;

- the diversity of boards; and
- the independence of board chairs.

<sup>1</sup> SEC Release No. 33-9089; 34-61175 ("Proxy Disclosure Enhancements"), December 16, 2009, available at [www.sec.gov/rules/final/2009/33-9089.pdf](http://www.sec.gov/rules/final/2009/33-9089.pdf). The rules apply to proxy and information statements, annual reports and registration statements under the Exchange Act, and registration statements under the Securities Act as well as the Investment Company Act. They do not apply to foreign private issuers. For an extensive discussion of the practical implications of the reform and a host of other topics related to planning for the 2010 proxy season, see "Planning for the 2010 Proxy Season: New Rules, Evolving Issues," Davis Polk & Wardwell webcast, January 6, 2010, available at <http://www.davispolk.com/Davis-Polk-Hosts-Web-Forum-on-2010-Proxy-Season-01-06-2010>.

<sup>2</sup> In response to uncertainty regarding the February 28, 2010 effective date, the SEC issued an interpretive release with helpful guidance on the applicability of the new rules. See *Proxy Disclosure Enhancements Transition*, available at <http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm>.



The rules add to the list of responsibilities that boards and committees must perform in discharging the company's disclosure requirements, and there is some risk that this will add uninformative bulk to proxy statements that are in many cases already overlong and unreadable. On the positive side, the new rules can provide a platform for boards to present, in a reasoned and non-defensive manner, the thought process reflected in the company's compensation and corporate governance practices.

## Overview

The rules require public companies to provide the following:

- New disclosure regarding the qualifications and skills of director nominees and directors<sup>3</sup> as well as added disclosure regarding directorships within the past five years (instead of just current directorships)<sup>4</sup> and involvement in an expanded list of legal proceedings within the past ten years (instead of just five years).<sup>5</sup>
- New disclosure focusing on compensation-related risks for all employees (not just named executive officers), although the requirement applies only if the risks are considered "reasonably likely" to have a "material adverse effect" on the company.<sup>6</sup>
- New disclosure regarding the board's role in risk oversight.<sup>7</sup>
- Disclosure concerning board leadership structure (i.e., whether the chairman is also the CEO or on the appointment and functions of a lead independent director).<sup>8</sup> Companies are also required to discuss whether diversity is a factor in the selection of board candidates.<sup>9</sup>
- New disclosures regarding fees paid to compensation consultants and affiliated entities if a consultant that is

providing executive or director compensation consulting services, or any of its affiliates, provides other services over \$120,000.<sup>10</sup>

- The requirement to report the value of stock and option awards at the aggregate "grant date fair value" of such awards (instead of by the dollar amount expensed during the year for financial statement purposes).<sup>11</sup>
- The requirement to report the results of shareholder votes within four days on Form 8-K (instead of in the next periodic report).<sup>12</sup>

## Transition to the New Disclosure Rules

In general, the rules apply to filings made on or after February 28, 2010 by companies with a fiscal year-end on or after December 20, 2009. If a preliminary proxy is required and the definitive proxy is filed after February 28, the preliminary proxy must also comply. Companies with fiscal year-ends before December 20, 2009, in general, do not have to comply with the new rules until the 2011 proxy season, after they file their 2010 Form 10-K.

Voluntary compliance with the rules, or any aspect of them, is permitted, with this exception: if an issuer elects to adopt the rule change to the reporting of equity award values in the summary compensation table, it must also comply with all of the other Regulation S-K amendments. Finally, if a new registrant or fund files a registration statement on or after December 20, 2009 (such as for an IPO or as a first registration on Form 10), compliance with the new rule would be required for the registration statement to be effective on or after February 28, 2010.

*Source: See Proxy Disclosure Enhancements Transition, available at <http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm>.*

<sup>3</sup> Item 401(e)(1) of Regulation S-K, as amended.

<sup>4</sup> Item 401(e)(2) of Regulation S-K, as amended.

<sup>5</sup> Item 401(f)(7)-(8) of Regulation S-K, as amended.

<sup>6</sup> Item 402(s) of Regulation S-K, as amended.

<sup>7</sup> Item 407(h) of Regulation S-K, as amended.

<sup>8</sup> *Id.*

<sup>9</sup> Item 407(c)(2)(vi) of Regulation S-K, as amended.

<sup>10</sup> Item 407(e)(3)(iii)(A)-(B) of Regulation S-K, as amended.

<sup>11</sup> Item 402(c)(2)(v)-(vi) of Regulation S-K, as amended.

<sup>12</sup> Item 5.07 of Form 8-K, as amended.

## Director and Nominee Disclosure

The new rules require companies to go beyond the basic resume of board candidates and to identify, for each director and nominee, the specific experience, qualifications, attributes or skills that led the board to nominate the person. If material, this additional disclosure should cover more than the past five years. Shareholders who nominate directors must also provide this additional information regarding their nominees. Recent guidance from the SEC emphasizes that disclosure should be provided on an individual, director-by-director basis, and that groupings of directors under particular attributes will not suffice.<sup>13</sup>

**Skill set disclosure** Disclosure of individual skill sets requires a tricky balance. As any nominating committee knows, a resume is only a starting point. A board selection process is more like assembling a chamber orchestra than an all-star team. For certain directors, their “objective” credentials have a self-evident link to their contribution to the board. In other cases, though, the essence of a director’s contribution lies in intangibles not discernible from a resume. While it is perfectly appropriate to identify these qualities in the nomination process and in the board’s annual self-assessment, including them in a proxy statement is a different matter.

How should a company present the information without seeming to make invidious distinctions among board members? A range of approaches is possible, including the following:

- **Basic attribute discussion** Simply add a sentence to each director’s biography highlighting one or more attributes: e.g., “Mr. Smith has a chemical engineering background that is relevant to our industry,” or “Ms. Harris’s experience as the CEO of a high-growth company has given her insights into the challenges that we expect to face.” Companies taking this approach should limit it to experiences or skills that are derivable from the resume and be wary of individual discussions of “soft” qualities like integrity and collegiality, for the simple reason that highlighting one such quality in an individual director tends to underscore its absence in the descriptions of others.

- **Skills and experience matrix** While it is convenient to present a version of the skills and experience matrix that many nominating committees already use, such a table can lend a misleading appearance of analytical rigor. Besides, there is a tendency in such exercises to ensure that each column describing a quality has a cell checked for at least one director, and that the row for each director is checked in at least one cell. The resulting disclosure could suggest that the board has already reached perfect harmonic balance, which may overstate the case.
- **Overview disclosure of composition philosophy** Regardless of the approach used to discuss attributes on an individual basis, companies should consider including disclosure that presents an overall philosophy of and process for board composition. That process should balance the qualities expected from all directors—such as integrity, collegiality, collaborative spirit, ability and willingness to make a commitment—with the distinctive attributes contributed by individual members. See the box on page 4 for an example of the subjects that such an overview could address.

The rule does not mandate similar disclosure with regard to service on board committees. However, disclosure will be required if an individual is chosen to serve on the board because of certain qualifications or attributes related to committee service (such as financial expertise for a director on the audit committee). Disclosure of “risk assessment” skills was also deleted as an express requirement but should be discussed if relevant.

**Directorships held and legal proceedings** The new rule requires disclosure of directorships held within the past five years (not just current directorships) and extends the look-back period for disclosure of legal proceedings involving a director, nominee, or executive officer from five to ten years. The legal proceedings for which disclosure is required include the following:

- any judicial or administrative order, judgment decree, or finding (not subsequently reversed, suspended or vacated) relating to an alleged violation of:
- federal or state securities or commodities laws;
- financial institution or insurance laws or regulations (including any injunction, order or disgorgement or restitution, civil money penalty or cease-and-desist order, or removal or prohibition order); or

<sup>13</sup> *Compliance & Disclosure Interpretations (Regulation S-K)*, Question 116.5, January 20, 2010 (last update), available at [www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#116-05](http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#116-05).

- laws or regulations prohibiting mail or wire fraud or fraud in connection with any business entity; or
- any disciplinary sanctions or orders (not subsequently reversed, suspended or vacated) imposed by a self-regulatory organization, registered entity, or equivalent entity that has disciplinary authority over its members.

Before the amendments, companies were only expected to disclose determined violations of securities or commodities laws. The new rule expands the requirement to alleged violations and settlements with government entities, but not to settlements of civil proceedings among private litigants. Moreover, as for the previous regime, disclosure of these additional legal proceedings is only necessary if it is material to an evaluation of the ability or integrity of the director, director nominee, or executive officer. Finally, this enhanced disclosure also applies to registered investment companies.<sup>14</sup>

**D&O questionnaires** Companies that have not already done so will need to amend their D&O questionnaires to elicit the

required information. The authors recommend the following changes:

1. Change the question that asks directors whether they hold any other directorships in publicly held companies to include not only other directorships currently held but also other directorships held during the past five years. For example, the questionnaire could state:

*“Do you presently hold, or have you held at any time during the past five years, any other directorships in publicly held companies, including any company organized outside of the United States or registered as an investment company?”*

Yes \_\_\_\_\_ No \_\_\_\_\_

*(See Amendments to Item 401(e)(2) of Regulation S-K”*

2. In the section of the questionnaire that requests information about a director, director nominee, or executive officers’ involvement in certain legal proceedings:
  - Modify the lead-in to inquire about proceedings occurring in the last 10 years rather than the last five years.

## Sample Overview Disclosure of Director Qualifications

In light of the new proxy disclosure requirements as to the “experience, qualifications, attributes and skills” of board nominees, it is appropriate to include an overview of the process that the board and nominating committee have followed in making the nominations reflected in the proxy statement. The following is intended not as a model but as a beginning point, indicating the subjects that this overview could address:

*“The Board of Directors, acting through the Nominating Committee, is responsible for assembling for shareholder consideration a group of nominees that, taken together, have the experience, qualifications, attributes, and skills appropriate for functioning effectively as a board. The Nominating Committee regularly reviews the composition of the board in light of the company’s changing requirements, its assessment of the board’s performance, and the inputs of shareholders and other key constituencies.*

*The Nominating Committee looks for certain characteristics common to all board members, including integrity, strong professional reputation and record of achievement, constructive and collegial personal attributes, and the ability and commitment to devote sufficient time and energy to board service.*

*In addition, the Nominating Committee seeks to include on the board a complementary mix of individuals with diverse backgrounds and skills reflecting the broad set of challenges that the board confronts. These individual qualities can include matters like experience in the company’s industry, technical experience (for example, financial or technological expertise), experience gained in situations comparable to the company’s [e.g., growth companies, companies that grow through acquisitions, companies that are restructuring], leadership experience, and relevant geographical experience.”*

<sup>14</sup> Item 22(4) (ii) of Schedule 14A.

- Add the following questions to solicit information about the additional legal proceedings that will be enumerated in Item 401(f) of Regulation S-K as a result of the amendments:

“(i) Have you been the subject of, or a party to, any federal or state judicial or administrative order, judgment, decree, or finding, not subsequently reversed, suspended or vacated, relating to an alleged violation of:

(a) any federal or state securities or commodities law or regulation; or

(b) any law or regulation respecting financial institutions or insurance companies including, but not limited to, a temporary or permanent injunction, order of disgorgement or restitution, civil money penalty or temporary or permanent cease-and-desist order, or removal or prohibition order; or

(c) any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity?

*Note: This question includes settlements but does not apply to any settlement of a civil proceeding among private litigants.*

Yes \_\_\_\_\_ No \_\_\_\_\_

(ii) Have you been the subject of, or a party to, any sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization (i.e., any national securities exchange, registered securities association, registered clearing agency or the municipal securities rulemaking board), any registered entity (i.e., a board of trade designated as a contract market under Section 7 of the Commodity Exchange Act; a derivatives transaction execution facility registered under Section 7a of the Commodity Exchange Act; a derivatives clearing organization registered under Section 7a-1 of Commodity Exchange Act; and a board of trade designated as a contract market under Section 7b-1 of the Commodity Exchange Act), or any equivalent exchange, association, entity, or organization that has disciplinary authority over its members or persons associated with a member?

Yes \_\_\_\_\_ No \_\_\_\_\_

*(See Amendments to Item 401(f) of Regulation S-K (Involvement in Certain Legal Proceedings))”*

3. Amendments to Item 401(e) of Regulation S-K require the company to disclose the specific experience, qualifications, attributes, or skills that led the board of directors to conclude that a person should serve as a director for the registrant at the time the disclosure is made, in light of the registrant’s business and structure. Companies should consider preparing an initial draft of this disclosure for review by each director.

## Compensation Programs and Risk

There has been much debate in the wake of the financial crisis about the extent to which the crisis was caused or exacerbated by compensation systems that tended to encourage imprudent risk taking.<sup>15</sup> The SEC originally proposed a rule that would have required disclosure of any such risks that “may have” a “material effect on the company.” The vagueness of this proposed language led to numerous comments by the public, since in hindsight all sorts of unexpected factors might be thought to have had a material impact.

In the final formulation of the rules, the SEC retreated to a formulation that requires public companies—other than smaller reporting companies—to disclose any risks related to their compensation policies and practices, but only to the extent they are “reasonably likely to have a material adverse effect on the registrant.” While this is nominally a risk disclosure requirement, as a practical matter it will rarely lead to disclosure, since any company that really believes that its policies are “reasonably likely” to have a material adverse effect on business would presumably change those policies. Still, compliance with the rule will require that companies go through a risk assessment exercise that may enhance compensation practices and disclosure.

The SEC provides examples of situations that could, in theory, trigger the need for disclosure. These include compensation programs:

- at a business unit that carries a significant portion of a company’s risk profile;
- at a business unit with compensation that is structured significantly differently from that of other units;

<sup>15</sup> For a discussion of these issues, see Matteo Tonello, “Overseeing Risk Management and Executive Compensation,” in *Id.*, *The Role of the Board in Turbulent Times: Leading the Public Company to Full Recovery*, The Conference Board, Research Report 1452, 2009. Also see *Final Report of The Conference Board Task Force on Executive Compensation*, The Conference Board, September 2009, p. 34 for a review of sensitive compensation practices for which the task force recommends additional voluntary disclosure by corporations.

## Compliance Checklist for Risk and Compensation Requirements

The board should consider establishing a process for the evaluation of material adverse effects that are reasonably likely to derive from the company's compensation policy and practices. The following checklist can provide preliminary guidance for the purpose of establishing such process.

1. Coordinate with various departments and board on an ongoing basis. In particular, compensation and audit committees should expect to receive any material compensation-related information directly from HR, the risk management department, and legal personnel.
2. Conduct fact-specific inquiry into whether a compensation policy or practice gives rise to a material risk.

*Does your company have compensation policies and practices that may cause material risks?*

- Inventory your compensation policies, plans, and arrangements.
- Identify material risks to the company and evaluate compensation programs in relation to these risks.
- Consider the risk factors identified in the company's Form 10-K.

*Does the company have any business unit:*

- that carries a significant portion of a company's risk profile;
- with compensation that is structured differently from that of other units;
- that is significantly more profitable than other units; or
- where compensation expense is a significant percentage of the unit's revenues?

*Does the company have any compensation policies that vary significantly from the overall risk and reward structure of the company? Any of the following may raise a red flag:*

- Short-term targets
- Targets based on a single metric
- Targets with metrics that may be easily manipulated
- Lump-sum cash payments
- Immediate vesting

- Payment upon completion, without regard to quality of revenue or income
- Employees whose compensation differs significantly from that of the broader population
- Highly compensated employee participants
- Rewarding sales of complicated products or services without adequate training or information given to the sellers

*Does your company have policies that are intended to mitigate risk? Such policies may include:*

- Internal risk audits
- Clawbacks
- Holdbacks
- Mandatory deferrals
- Stock ownership commitments
- Arrangements for employees with compliance, internal audit, and similar roles

3. Determine whether the policy or practice is "reasonably likely" to cause a material adverse effect on the company.
4. Based on such determination, consider revisiting compensation policies and practices to mitigate identified risks.
5. In those situations where the company concludes that the existing compensation policy serves well the business strategy and that any correlated risk is within the tolerance parameters of the company's risk appetite, develop disclosure—in consultation with the compensation committee—to describe the risks and articulate the rationale for the decision to incur them.
6. Maintain a record of the evaluative process, including the role of the compensation committee.

- at a business unit that is significantly more profitable than other units;
- at a business unit where compensation expense is a significant percentage of the unit’s revenues; and
- that vary significantly from the company’s overall risk and reward structure (e.g., if bonuses are awarded for accomplishing short-term tasks, whereas the income and risk to the company from the tasks extend over longer periods).

Since an appropriate inquiry requires an evaluation of compensation policies for all employees, not just named executive officers, companies should coordinate the analysis with their human resources, risk management, and legal departments as well as with the compensation and audit committees. The evaluation should include, if appropriate, measures that companies may have adopted to mitigate risk, such as stock ownership requirements, internal audits, and clawback policies.

If a company concludes that no disclosure is necessary, the rules do not require an affirmative statement to that effect. However, some companies may consider taking a proactive stance and voluntarily make such a statement in the interest of enhanced disclosure. In fact, companies that are silent on the issue could later receive an SEC comment inquiring whether and how the company made such a determination. In any case, it is a good practice to create a record of the evaluative process, including the role of the compensation committee.

Because the rule encompasses more than named executive officers, the new disclosure should not be included in the Compensation Disclosure and Analysis (CD&A) section of the proxy statement but rather form a stand-alone section.

## Diversity in the Nomination Process

Companies have long been required to describe the board’s process for identifying and evaluating nominees under Item 407(c) to Regulation S-K. The new rules expressly expand this requirement to include whether and how the nominating committee or board considers diversity in identifying nominees. The rule also provides that if the company has a formal policy with respect to considering diversity, it should discuss how the policy is implemented and its effectiveness assessed.<sup>16</sup>

It is likely that many companies will ultimately omit additional disclosure on implementation and effectiveness by concluding that while diversity is one factor that the board or committee may consider in the nomination process, it constitutes less than a formal policy. In these cases, companies should be prepared to address possible SEC comments inquiring why such a determination was made.

The rule does not define “diversity,” and the SEC makes clear that the rule is meant to be interpreted broadly, citing as possible “diverse” criteria such matters as differences in viewpoint, professional experience, education, and skill as well as race, gender, and national origin. While the rule seems designed to encourage boards to consider diversity in director selection, companies are left with significant discretion in determining what disclosure, and what policy, if any, is appropriate. Consistent with the philosophy disclosure regarding board composition discussed above, companies should consider providing a discussion of diversity as among the criteria used by the nominating committee in choosing a director or nominee. (See “Sample Overview Disclosure of Director Qualifications” on p. 4).

## Board Leadership Structure

New Item 407(h) requires disclosure of a company’s board leadership structure, including whether and why the company has chosen to combine or to separate the principal executive officer and board chairman positions. A company is also required to state why the company believed that its leadership structure is the “most appropriate structure for it at the time of filing.”<sup>17</sup> If the same person serves as both board chairman and CEO, the company must disclose whether the board has a lead independent director and that director’s role.

Although in many cases they have failed to win wide shareholder support, resolutions to separate the chair and CEO positions have been a mainstay of the activist community and were filed in increasingly large numbers in recent proxy seasons. For this reason, proxy statements by peer companies facing similar proposals can be a useful resource for those seeking precedents for leadership structure disclosure.

<sup>16</sup> Question 128.A.01 of the S-K CD&I at [www.sec.gov/divisions/corfin/guidance/regs-kinterp.htm](http://www.sec.gov/divisions/corfin/guidance/regs-kinterp.htm)

<sup>17</sup> SEC Release 33-9089, p. 39.

Directors should be mindful that the requirement is limited to an explanation of why the board has concluded that, in light of present circumstances, the current arrangement best suits the company's needs. As a result, companies should consider avoiding adding to their disclosure documents any defensive statement on this issue, including the assertion that the chosen approach to board leadership is the best in all cases and for all time. If the company has combined the chair and

CEO roles, it would be helpful to explain that the lead director plays an active role that covers many of the functions that an independent chair would otherwise perform.

As a reference point for a description of lead director responsibilities, companies should consider reviewing the proxy voting policy adopted by RiskMetrics Group with respect to independent chair shareholder proposals (see box).

## RiskMetrics' Voting Policies on Independent Chair Shareholder Proposals

Under its voting policies, proxy advisor RiskMetrics generally recommends a vote *for* shareholder proposals requiring that the chairman's position be filled by an independent director, unless the company maintains *all* the elements of the following counterbalancing governance structure:

- Designated lead director, elected by and from the independent board members with clearly delineated and comprehensive duties. (The role may alternatively reside with a presiding director, vice chairman, or rotating lead director; however, the director must serve a minimum of one year in order to qualify as a lead director.) The duties should include, but are not limited to, the following:
  - presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors;
  - serves as liaison between the chairman and the independent directors;
  - approves information sent to the board;
  - approves meeting agendas for the board;
  - approves meeting schedules to assure that there is sufficient time for discussion of all agenda items;
  - has the authority to call meetings of the independent directors;
  - if requested by major shareholders, ensures that he is available for consultation and direct communication;
- Two-thirds independent board;
- All independent key committees;
- Established governance guidelines;
- A company in the Russell 3000 universe must not have exhibited sustained poor total shareholder return (TSR) performance, defined as one- and three-year TSR in the bottom half of the company's four-digit GICS industry group (using Russell 3000 companies only), unless there has been a change in the Chairman/CEO position within that time. For companies not in the Russell 3000 universe, the company must not have underperformed both its peers and index on the basis of both one-year and three-year total shareholder returns, unless there has been a change in the Chairman/CEO position within that time.
- The company does not have any problematic governance or management issues, examples of which include, but are not limited to:
  - egregious compensation practices;
  - multiple related-party transactions or other issues putting director independence at risk;
  - corporate and/or management scandals;
  - excessive problematic corporate governance provisions; or
  - flagrant actions by management or the board with potential or realized negative impacts on shareholders.

*Source: U.S. Corporate Governance Policies—2009 Updates, RiskMetrics Group, November 25, 2008, p. 10.*

## The Role of the Board in Risk Oversight

Tacked onto new Item 407(h) is a risk disclosure requirement that in its entirety reads as follows: “In addition, disclose the extent of the board’s role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board’s leadership structure.”

This is a nod in the direction of addressing the risk oversight failures that played so prominently in the financial crisis. Unlike the proposed rule, the final formulation of the SEC rule focuses on the board’s role in risk *oversight* as opposed to risk *management*, recognizing that, as commentators argued, it is senior executives rather than the board who actually manage risk. The rule does not define “risk,” but the adopting release cites credit risk, liquidity risk, and operational risk as being among the types of risk that the rule is intended to address. The requirement to describe the effect that the board’s risk oversight role has on its leadership structure is puzzling, as in most cases there is not likely to be any real linkage between the two.<sup>18</sup>

An appropriate response to the item should probably begin by framing the question. Companies face all sorts of business risk: competitive, technological, regulatory, legal, personnel, financial, and many others. Most companies already describe these at length in their Item 101 business descriptions, in the management’s discussion and analysis (MD&A) or in their risk factor sections, among other places. The rule can hardly be interpreted as requiring companies to provide an itemized description of how the board oversees each identified risk. For nonfinancial companies, the disclosure should address at a minimum the board’s general risk oversight procedures (including a reference to the company’s enterprise risk management system if there is one), supplemented by a description of the major features of the company’s overall disclosure controls and procedures as well as the special role that board committees may play in connection with particular risks. For

financial companies, more detailed disclosure will likely be appropriate, including a discussion of the set of metrics used to assess risk exposure and of the resources dedicated to risk mitigation or avoidance.

## Compensation Consulting Fees

Item 407 of Regulation S-K has required that companies describe any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. Under the new rule, companies also owe additional disclosure about the fees paid to compensation consultants and their affiliates in connection with providing other services if the cost of such services, together with fees paid to affiliates of the consulting firm, exceeds \$120,000. The reference to affiliates is significant because some prominent consulting firms are part of larger entities that include insurance brokerage, actuarial services, and other businesses. The complexity of these organizations makes it difficult for some companies to gather the required information.<sup>19</sup>

The required disclosure varies depending on who engages the consultant. If the consultant is engaged by the board or compensation committee at a cost exceeding \$120,000 during the last fiscal year (for services other than executive compensation consulting services), then the company will be required to disclose:

- the aggregate fees paid for executive compensation consulting services;
- the aggregate fees paid for non-executive compensation services;
- whether the decision to engage the consultant or its affiliates for any other services was recommended or made by management; and
- whether the board or compensation committee approved these other services.

<sup>18</sup> In 2007, in collaboration with a working group of leading experts and risk professionals from the corporate and academic community, The Conference Board developed a road map for board members approaching their risk oversight responsibilities. See Matteo Tonello, *Emerging Governance Practices in Enterprise Risk Management*, The Conference Board, Research Report 1398, 2007. Also see Id., *Risk Oversight Handbook: Legal Standards and Board Practices*, The Conference Board, forthcoming, 2010.

<sup>19</sup> For a discussion of possible conflicts of interests arising from the retention of compensation consultants by boards of directors, see Carolyn K. Brancato and Alan A. Rudnick, *The Evolving Relationship between Compensation Committees and Consultants*, The Conference Board, Research Report 1382, 2006.

If the board or compensation committee does not hire its own consultant, additional disclosure regarding management's consultant is required if the cost of the additional services exceeded \$120,000. The required disclosure includes:

- the aggregate fees paid for executive compensation consulting services; and
- the aggregate fees paid for non-executive compensation services.

Under the new rules, an exception from the disclosure requirement applies in the following situations:

- when the only role of the compensation consultant in providing executive compensation services is in connection with broad-based plans that do not discriminate in favor of executives or directors, such as 401(k) plans and health insurance plans;
- when the services of the compensation consultant are limited to providing non-customized information such as surveys or other data based on parameters that are not developed by the consultant;
- when the board or compensation committee hires its own compensation consultant. (In this case, disclosure is not necessary for the compensation consultant retained by senior management, regardless of how much may have been paid.)

It is advisable that companies required to make a disclosure under the rule consider including statements for the purpose of:

- explaining the rationale for receiving other professional services from the consultant or affiliated entities;
- describing preventive measures (e.g., conflict walls or other safeguards) adopted to avoid a situation in which the simultaneous engagement for other services would affect the independence of the compensation-related advice provided by the consultant to directors or senior executives.

## Equity Award Value Reporting

The rules reform the historic method of disclosing equity awards and require companies to report the value of stock and option awards in the summary compensation table and director compensation table at the aggregate "grant date fair value" of such awards.

Until now, equity awards have been reported at the dollar amount expensed during the year for financial statement purposes. The change to the grant date fair value approach may affect not only the total compensation reported but also the composition of the named executive officer group, e.g., in the case of new hire awards.

## Equity Award Reporting: Old Rules vs. New Rules

### Old Rules

- The value of stock options, restricted stock awards, and RSUs reported as compensation for a covered year is the annual accounting expense.
- Generally, expenses are charged over the vesting period, so awards granted in one year have a trailing effect over future years as they vest.

### New Rules

- The value of stock options, restricted stock awards, and RSUs reported as compensation is the aggregate grant date value in year of grant.
- Awards granted in one year have no trailing effect in future years.
- For awards with performance conditions, the grant date value is based on probable outcome of performance, with footnote for maximum potential.

Under the new rule, companies should present recomputed disclosure for each preceding fiscal year required to be included in the table. However, the rule does not require inclusion of different named executive officers for any preceding fiscal year based on re-computing the total compensation for those years.

The rule requires that awards subject to performance conditions be reported based on the probable outcome of performance conditions as of the grant date. The rule also requires footnote disclosure of the maximum value of the award, assuming that the highest level of performance is probable.

Since the new method of reporting could change the identities of a company's named executive officers in the 2010 proxy, companies that have received TARP assistance should be aware that, as a result of the amendment, the identities of the individuals subject to the TARP compensation restrictions (e.g., bonus restrictions, prohibition on golden parachute payments) could also vary.

## Accelerated Vote Result Reporting

A new Form 8-K item 5.07 requires companies to disclose the results of a shareholder vote within four business days of the end of the meeting, instead of the previous requirement to report the results in the next quarterly or annual report.

Where results are not known by the deadline, companies are permitted to disclose preliminary voting results and file an amended Form 8-K, reporting the final results within four business days after the final results become known.

Any shareholder meeting that takes place on or after February 28, 2010 is subject to the new Form 8-K Item 5.07 reporting requirement.

This report is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.

## About the Authors

**William M. Kelly** is a corporate partner at Davis Polk & Wardwell LLP and a founder of the firm's Menlo Park office. He primarily represents technology companies and their investors and advises in mergers and acquisitions, strategic alliances, corporate governance, and securities law compliance. He has been involved in some of the most significant M&A transactions in Silicon Valley and acts as regular corporate counsel to a number of tech companies. He also acts as special counsel to boards of directors, both tech and non-tech, in takeover defense and other sensitive situations, and is a frequent lecturer in M&A and corporate governance matters. Mr. Kelly is a Director and Chair of the Audit Committee of MIPS Technologies. Before joining Davis Polk, he was General Counsel and held other senior business roles at Silicon Graphics, Inc.

Mr. Kelly is admitted to the bars of California and New York. He earned an A.B., cum laude, from Columbia University and a J.D. from Columbia Law School, where he was a Harlan Fiske Stone Scholar.

**Mutya Fonte Harsch** is an associate in Davis Polk & Wardwell LLP's mergers and acquisitions department and a practice resources editor for the firm. She has published a number of articles on mergers and acquisitions matters and corporate governance issues. Before rejoining the firm, she was Assistant General Counsel to Warner Chilcott.

Ms. Harsch is admitted to the bars of California and New York. She earned a B.A., with honors, from the University of California at Berkeley and a J.D. from the University of California at Berkeley (Boalt Hall) Law School.

## About the Series Director

**Matteo Tonello** is director, corporate governance research, at The Conference Board in New York. For The Conference Board, Tonello has conducted governance and risk management analyses and research in collaboration with leading corporations, institutional investors and professional firms. Also, he has participated as a speaker and moderator in educational programs on governance best practices. Recently, Tonello served as a member of the Technical Advisory Group to The Conference Board Task Force on Executive Compensation. Before joining The Conference Board, he practiced corporate law at Davis Polk & Wardwell. Tonello is a graduate of Harvard Law School.

## About The Conference Board

The Conference Board is the world's preeminent business membership and research organization. Best known for the Consumer Confidence Index and the Leading Economic Indicators, The Conference Board has, for over 90 years, equipped the world's leading corporations with practical knowledge through issues-oriented research and senior executive peer-to-peer meetings.

For more information on this report, please contact:

**Matteo Tonello**, director, corporate governance research, at **212 339 0335** or **matteo.tonello@conference-board.org**.

Copyright © 2010 by The Conference Board, Inc. All rights reserved. The Conference Board<sup>®</sup>, and the torch logo are registered trademarks of The Conference Board, Inc.

The Conference Board, Inc. 845 Third Avenue, New York, NY 10022-6600, United States / 212 759 0900 / [www.conference-board.org](http://www.conference-board.org)

The Conference Board Europe Chaussée de La Hulpe 130, box 11, B-1000 Brussels, Belgium / + 32 2 675 54 05 / [www.conference-board.org/europe.htm](http://www.conference-board.org/europe.htm)

The Conference Board Asia-Pacific 22/F, Shun Ho Tower, 24-30 Ice House Street, Central, Hong Kong, SAR / + 852 2804 1000 / [www.conference-board.org/ap.htm](http://www.conference-board.org/ap.htm)

Conference Board India 701 Mahalaxmi Heights, A Wing, Keshav Rao Khadye Marg, Mahalaxmi, Mumbai 400 011, India / + 91 9987548045 / [www.conference-board.org/worldwide/india.cfm](http://www.conference-board.org/worldwide/india.cfm)

The Conference Board of Canada 255 Smyth Road, Ottawa, ON K1H 8M7, Canada / 613 526 3280 / [www.conferenceboard.ca](http://www.conferenceboard.ca)