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The SEC's New Corporate Governance and Compensation Disclosure Requirements

On December 16, 2009, the SEC approved final rules relating to key risk, corporate governance and compensation matters. The new rules become effective February 28, 2010 and will affect most companies in the 2010 proxy season whose fiscal years end on or after December 20, 2009. The new rules will not generally affect companies with fiscal year-ends before December 20, 2009 until the 2011 proxy season. The new rules will also require companies to report shareholder voting results on a new Form 8-K item. The final rules (SEC Release No. 33-9089) were adopted substantially as proposed with the changes described below.

The new rules have a number of practical implications which we discussed in a webcast, "Planning for the 2010 Proxy Season: New Rules, Evolving Issues," held on January 6, 2010. These include:

- New disclosure regarding director nominees and directors will be required, including directorships within the past five years (instead of just current directorships) and involvement in an expanded list of legal proceedings within the past ten years. Companies should ensure that their D&O questionnaires reflect these changes.
- New disclosure focusing on compensation-related risks for all employees (not just named executive officers) will be required if the risks are "reasonably likely" to have a "material adverse effect" on the company.
- Companies will also be required to provide disclosure regarding the board's role in risk oversight.
- Companies will be required to describe the board leadership structures of the company and the qualifications and skills of individual directors and nominees. Companies will also be required to discuss whether diversity is a factor in the selection of board candidates.
- Companies must also provide certain new disclosure 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 also provides other services over $120,000. In a significant change from the proposal, under the new rule, if the board or compensation committee hires its own consultant and management also has a compensation consultant, disclosure is not necessary for consultants working with management even if the consultant hired by management provides other services. Thus, if the board or compensation committee hires its own compensation consultant for executive compensation consulting services and neither the consultant nor any of its affiliates provides any other additional services, no disclosure will be required.

  If a company is required to make such disclosure, it may consider providing additional disclosure, such as information regarding conflict walls or other arrangements, to describe why the provision of additional services should not affect the "independence" of the executive and director compensation-related advice of the consultant and the rationale for using the consultant or affiliated entities to provide other services. Often, a strong case can be made as to why the company's selection of a particular service provider is in the best interests of the company and its shareholders.
- Companies must report equity awards at their "aggregate grant date fair value" which can significantly change the value reported for the awards in the summary compensation table. The new method of reporting could also change the identities of a company's named executive officers in the 2010 proxy. For companies that have received TARP assistance, this could also

change the identities of the individuals subject to the TARP compensation restrictions (e.g., bonus restrictions, prohibition on golden parachute payments).

The SEC issued an interpretive release ("Proxy Disclosure Enhancements Transition," December 22, 2009) which clarified the applicability of the rules.[1] For issuers whose fiscal years end on or after December 20, 2009, Form 10-Ks, proxy statements and registration statements must comply with the new rules if filed on or after February 28, 2010. A proxy statement that contains information that will be incorporated into a Form 10-K must comply with the new rules if the definitive proxy statement is filed after February 28, 2010. If the issuer is required to file a preliminary proxy statement and the issuer expects to file a definitive proxy statement after the effective date, the preliminary proxy statement must also comply with the new rules even if it is filed before February 28.

An issuer whose fiscal year ends before December 20, 2009 does not have to comply with the new rules until it files its 2010 Form 10-K. Proxy and registration statements for such reporting issuers filed before then are not subject to the new rules, even if filed after February 28, 2010. Voluntary compliance is permitted except that 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.[2]

The new rules amend Items 401, 402 and 407 of Regulation S-K, Schedule 14A and Form 8-K and Forms N-1A, N-2 and N-3 for registered investment companies. 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. It does not apply to foreign private issuers.

Compensation programs and risk

A new Item 402(s) of Regulation S-K requires companies to provide narrative disclosure of any risks related to their compensation policies and practices to the extent they are "reasonably likely to have a material adverse effect on the registrant." Notably, the new rule requires an evaluation of compensation policies and practices for all employees, not just named executive officers. Because the rule encompasses more than named executive officers, the new disclosure will be stand-alone and will not be part of the CD&A as originally proposed. Smaller reporting companies are exempt.

The final rule significantly narrows the circumstances in which disclosure is required. Under the proposed rule, disclosure was required if the risks "may have" a "material effect on the company." Application of the "reasonably likely" threshold, which parallels the disclosure threshold contained in required MD&A disclosure, should be generally familiar to most companies. Further, the new rule limits disclosure to compensation policies and practices reasonably likely to have a material "adverse" effect on the company, as opposed to any "material effect" as proposed. Thus, in determining whether disclosure is necessary, companies may consider other factors such as offsetting steps or controls designed to limit risks.

The new rule identifies examples of situations that could trigger the need to provide disclosure. These examples include compensation programs:

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

[1] Related C&DIs were also released by the Division of Investment Management ("Frequently Asked Questions About Proxy Disclosure Enhancements Transition for Registered Investment Companies," December 23, 2009)

[2] The C&DIs also provide that 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 in order for the registration statement to be effective on or after February 28, 2010.

- at a business unit with compensation that is structured significantly differently from that of other units;
- 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).

If a company determines that disclosure under the rule is required, issues that it may need to address, include:

- how the design and implementation of its compensation programs incentivize employees to take risks;
- whether its compensation programs encourage short-term or long-term risk taking (e.g., through clawbacks or holding periods);
- whether the company adjusts its compensation programs to respond to changes in its risk profile and any material adjustments made; and
- the extent to which the company monitors its compensation programs to ensure that they are not incentivizing employees to respond in ways that conflict with the company's risk management objectives.

These situations and issues are merely examples and a company's decision as to whether this discussion is necessary and, if so, what to discuss will depend on the company's particular circumstances.

Companies should consult with their compensation committees to determine whether and if so, what, disclosure should be made. In light of the new limitations contained in the final rule, however, we would expect many, if not most, companies to reasonably conclude that no disclosure is required. Consistent with prior practice, a company that so concludes is not required to make an affirmative statement to that effect.

Director and nominee disclosure

Item 401 to Regulation S-K currently requires companies to provide five-year background information regarding the business experience of directors and director nominees and information regarding current directorships and involvement in legal proceedings in the past five years.

Under the new rule, companies are required to disclose for each director nominee and director (whether or not up for re-election), the specific experience, qualifications, attributes or skills that led the board to conclude that the individual should serve as a director. If material, this additional disclosure should cover more than the past five years. A shareholder that nominates a director must also provide this additional information regarding its nominee(s).

The final rule eliminated similar disclosure with regard to service on board committees. However, disclosure will be required if an individual is chosen to serve on the board due to 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 disclosed if relevant.

The rule intentionally does not specify the particular information that should be disclosed with regard to a director or nominee. Indeed, companies will have flexibility in crafting the required disclosure.

The new rule also requires the disclosure of directorships held within the past five years (instead of only current directorships) and extends the look-back period for which disclosure of legal proceedings involving a director, nominee or executive officer is required from five to ten years. While not originally proposed, the final rule amends Item 401(f) to include additional legal proceedings for which disclosure is required to include:

- 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
  - 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.

Settlements of civil proceedings among private litigants need not be disclosed. As in the current rule, disclosure of these additional legal proceedings will not need to be made if it would not be material to an evaluation of the ability or integrity of the director, director nominee or executive officer. This enhanced disclosure will also apply to registered investment companies.

Diversity as a factor in the nominations process

Companies are currently required to describe the board's process for identifying and evaluating nominees under Item 407(c) to Regulation S-K. Some companies already disclose that they consider diversity as a factor in nominee selection. The new rule supplements the current requirement by specifically requiring companies to disclose whether and if so, how, a nominating committee (or board) considers diversity in identifying nominees. If a company has a diversity policy in place, the new rule will require disclosure of how the policy is implemented and how the nominating committee (or board) assesses the effectiveness of its policy. This enhanced disclosure will also apply to registered investment companies.

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: 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 will have significant discretion in determining what disclosure, and what policy, if any, is appropriate.

Board leadership structure and role in risk oversight

A new Item 407(h) requires disclosure of a company's board leadership structure including whether and why the company has chosen to combine or separate the principal executive officer and board chairman positions. Companies are also required to state the reasons why the company believes its leadership structure is most appropriate. If one person serves as the chairman and the CEO, the company must disclose whether the board has a lead independent director and that director's role. The SEC has stated that the rule is meant to increase transparency regarding the board's leadership structure, and is not meant to influence the actual leadership structure of the board.

Item 407(h) also requires disclosure of the board's role in the oversight of "risk." While not defined, the SEC's adopting release cites credit risk, liquidity risk and operational risk among the types of "risks" the rule intends to address. In particular, the rule requires a description of how the board administers its oversight function and the effect that this has on the board's leadership structure. Appropriate disclosure may also include:

- a description of the structures the board has in place to administer its oversight function, such as through the whole board or through a standing committee such as a risk committee or the audit committee;
- whether individuals who address the company's day-to-day risks report directly to the board as a whole or to a committee;
- the relationship between the board and senior management in managing material risks; and
- how the board or committee otherwise oversees risk management and control practices and receives risk-related information.

Registered investment companies must provide similar disclosure.

New disclosure regarding compensation consultants

Item 407 of Regulation S-K currently requires that companies describe any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. The new rule requires, for the first time, additional disclosure in certain circumstances about the fees paid to compensation consultants and their affiliates in connection with providing other services.

If the compensation consultant was engaged by the board or compensation committee and the cost of additional services provided by the consultant or its affiliates (other than executive compensation consulting services) exceeds $120,000 during the fiscal year, 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 has approved these other services.

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 exceeds $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.

If the compensation committee has its own consultant and management also has a compensation consultant, disclosure is not necessary for consultants that work with management regardless of the services provided. This exception is available without regard to whether management's consultant participates in board meetings.

The final rule eliminated disclosure regarding the nature and extent of additional services provided by the compensation consultant and its affiliates to the company in response to concerns regarding disclosure of confidential and competitively sensitive pricing information.

As proposed, the new rule provides an exception from the disclosure requirement for situations in which the compensation consultant's only role 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. Additionally, the new rule expands the exception to include situations where the compensation consultant's services are limited to providing non-customized information such as surveys or information that is based on parameters that are not developed by the consultant.

Changes to the reporting of the value of equity awards

Amended Item 402 of Regulation S-K requires the value of stock and option awards reported in the summary compensation table and director compensation table be disclosed at the aggregate "grant date fair value" of such awards. Previously, the rule required disclosure of the dollar amount expensed during the year for financial statement reporting purposes. The grant date fair value approach is widely preferred by most users of reported compensation data, and may affect not only the total compensation reported but also the composition of the named executive officer group.

The new rule will require companies providing Item 402 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 table. However, the new rule does not require inclusion of different named executive officers for any preceding fiscal year based on recomputing the total compensation for those years.

In response to comments, the new rule overrides a recent staff interpretation and requires that awards subject to performance conditions are to be reported in the summary compensation table, grants of plan-based awards table and director compensation table based on the probable outcome of performance conditions as of the grant date, with footnote disclosure of the maximum value of the award assuming the highest level of performance conditions is probable.

Accelerated vote result reporting

A new Form 8-K item 5.07 will require companies to disclose the results of a shareholder vote on the form within four business days of the end of the meeting instead of the current requirement to report the results in the next quarterly or annual report. Where results will not be known by the deadline, companies will be 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 are 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.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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