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Alert Memo

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SEC Adopts Compensation and Corporate Governance Disclosure Rule Changes

At its open meeting on December 16, 2009, the SEC adopted final rules amending compensation and corporate governance disclosure requirements for U.S. companies.[1] The rules become effective on February 28, 2010. We have outlined below the key takeaway points about the new rules.

Compensation Policies and Practices and Risk

- To the extent that compensation policies and practices for its employees create risks that are reasonably likely to have a material adverse effect on the company, it must discuss such policies and practices as they relate to its risk management practices and risk-taking incentives.

- The SEC raised the disclosure threshold from its proposal to "reasonably likely" from "may." Under prior SEC guidance, to which the SEC referred in adopting the new rules, the "reasonably likely" standard is higher than "possible" but lower than "more likely than not." Based on guidance in the adopting release, the impact is measured by reference to the company as a whole, and not to any particular business unit.[2]

  The change in disclosure threshold is significant and, although its stated purpose was to avoid voluminous and extraneous disclosure that could be prompted by a low bar, we suspect that few companies will find that the disclosure will be required. The adopting release acknowledges that companies can consider policies and practices that mitigate or balance incentives in deciding whether compensation-related risks are reasonably likely to have a material adverse effect. Companies must nonetheless examine compensation programs for all employees to reach a decision on the

[1] SEC Release No. 33-9089 (Dec. 16, 2009) (http://sec.gov/rules/final/2009/33-9089.pdf). These amendments were proposed in July 2009 (SEC Release 33-9052, July 10, 2009 (http://sec.gov/rules/proposed.shtml)). Also proposed at that time were certain clarifications to the proxy solicitation rules. The SEC decided to defer consideration of those proposed amendments in order to address them in the context of its proxy access proposal.

[2] Id. at 13.

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disclosure question. This is the season when compensation committees review 2009 performance awards and approve compensation arrangements and targets for future periods. Committees should refresh their practices to assure that they are appropriately addressing the implications of their compensation decisions for the company's risk profile. Our companion client memorandum of today's date[3] offers practical advice to orient the compensation committee's deliberations about risk.

- The new disclosure is not a requirement for the CD&A and thus not within the purview of the compensation committee report required under Item 407(e)(5) of Regulation S-K. Although the adopting release does not specify a location for the disclosure if it is required, we expect that companies will place it with other disclosures about compensation committee activities.

  The adopting release emphasizes that under existing rules, the CD&A must nonetheless address risk considerations if they are a material aspect of the company's compensation policies or decisions for named executive officers, and we believe that most companies will address risk as part of the CD&A (as companies were encouraged to do in the 2009 proxy season).[4]

- There is no requirement that a company make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect. We believe that volunteering this type of disclosure would be ill-advised.

- The new rules retain in their entirety the proposal's non-exclusive lists of illustrative situations where policies and practices may give rise to material risks and issues a company might address in its disclosure. The SEC makes clear that these are not exhaustive lists. It is also clear that a listed situation would not require disclosure unless the "reasonably likely" threshold is met.

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[3] Available at
http://www.cgsh.com/compensation_and_risk_compensation_committee_actions_under_new_sec_rules/.

[4] In a speech on executive compensation disclosure given on October 21, 2008, John White, then Director of the Division of Corporation Finance, noted that financial institutions receiving assistance under the Troubled Asset Relief Program ("TARP") were required to make certain disclosures about risk and compensation in their CD&A. He went on to note that, for non-TARP companies as well, "to the extent that [risk] considerations are or become a material part of a company's compensation policies or decisions, a company would be required to discuss them as part of its CD&A" and urged companies to consider these matters carefully as they prepared their CD&A. The speech is available at
http://www.sec.gov/news/speech/2008/spch102108jww.htm.

Stock and Option Award Reporting

- The Summary Compensation Table and Director Compensation Table must include disclosure of the aggregate grant date fair value of equity-based compensation awards, calculated in accordance with Financial Accounting Standards Board Codification Topic 718, Compensation – Stock Compensation,[5] for the fiscal year in which the awards are granted.[6] Unlike the old rule, the new rule does not require estimated forfeitures to be backed out from the value calculation for non-performance-based awards.[7]

- With respect to equity awards subject to performance conditions (as defined in the Glossary to Topic 718), the proposal could have been read (together with SEC interpretive guidance) to require disclosure in the Summary Compensation Table and the Director Compensation Table based on the maximum payout value without discounting for probable outcomes. The final rule clarifies that grant date value for this purpose should be based upon the probable outcome of the performance conditions, consistent with accounting estimates of cost to be recognized but disregarding estimated forfeitures. The grant date value of such performance-based awards assuming the highest level of performance should be disclosed in a footnote to the applicable table.

- To the extent disclosure for a fiscal year ending on or after December 20, 2009 is required, disclosure of equity-based awards also must be revised in accordance with the new rule for each preceding fiscal year set forth in the applicable table. The new calculation would be reflected in the total compensation column in the Summary Compensation Table but would not require any amendment of prior filings or alterations in the determination of named executive officers in prior fiscal years.

- In the proposal, the SEC solicited comment on the timing of disclosure for equity awards. In the final rule, the SEC decided not to change the existing rules concerning disclosure of equity-based awards in the year granted (as opposed to the year earned), but urged companies to include supplemental disclosure (including

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[5] Previously, Statement of Financial Accounting Standard 123 (revised 2004).

[6] Currently, disclosure of equity-based awards in the tables is based on the amount of expense recognized in each fiscal year in accordance with Topic 718 with respect to all outstanding awards, regardless of their grant date.

[7] In Compliance and Disclosure Interpretation 119.11 (http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm), the SEC approved the approach of "reversing out" forfeited awards from the reported values of option and stock awards, subject to certain conditions. It is not clear whether the SEC intends that concept to carry over into the new disclosure regime, although, if so, the concept would probably have a narrower application as it would appear to be potentially applicable only in the event an award were granted and forfeited in the same fiscal year.

tabular disclosure) of post-fiscal year end grants in the CD&A to the extent it facilitates understanding of compensation for such fiscal year.

- The SEC decided to retain the requirement to disclose the grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table (and in the footnotes to the Director Compensation Table), specifying the same approach to valuation of performance-based awards as is now required in the Summary Compensation Table.

- The SEC also did not adopt its own proposed change to the disclosure of salary and bonus amounts foregone at the election of an executive in return for non-cash awards. Such amounts should continue to be reported in the salary or bonus column of the Summary Compensation Table with footnote disclosure regarding the non-cash compensation, referring to the Grants of Plan-Based Awards Table where the award is reported.

Additional Director Disclosure

Director Qualifications

- Each year, a company must disclose for each director and director nominee – regardless of whether that person is slated for election that year – the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director of the company. The disclosure must speak as of the time it is made in light of the company's business and structure and is required for all nominees, regardless of whether advanced by the company or another proponent.

- The SEC did not retain the proposal's requirement to explain a person's qualifications for sitting on particular board committees or its proposal that companies describe a person's risk management skills, unless those qualifications and skills were among the reasons the board or proponent concluded that the person should serve as a director.

- The SEC retained the existing disclosure requirements in Item 407(c)(2)(v) of Regulation S-K about the specific minimum qualifications, qualities or skills considered by the nominating committee in slating director nominees to promote an evaluation of how well the board meets its own standards.

- The SEC has expressly allowed companies significant flexibility to decide what information should be disclosed. Despite the SEC's caution against boilerplate, however, companies may find it challenging to describe a person's qualifications without resorting to stock phrases. In any event, companies should avoid puffery in making these disclosures.

- Companies must also consider how to elicit the required information and develop the disclosure. For some companies, the D&O questionnaire may be an appropriate starting point; for others, it may be more efficient for the disclosure to be drafted based on the director's biographical details and then reviewed by the director.

- Going forward, director succession planning should be refined to take into account the new requirement so that any eventual disclosure reflects the realities of the decision-making process.

<u>Other Directorships</u>

- A company must disclose for each director any board seats held at other companies at any time during the prior five years, regardless of whether they are currently held. Companies should revise their D&O questionnaires accordingly.

<u>Director Diversity</u>

- A company must disclose whether it considers diversity in its selection of director nominees and, if so, how it does so.

- Significantly, "diversity" is not defined, which provides companies with great latitude and surely disappoints those who would use disclosure as a means of promoting social policies. Diversity can include "differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity" or "diversity concepts such as race, gender and national origin."

- If the nominating committee or the board has a policy with respect to the consideration of diversity in identifying director nominees, the company must describe how it is implemented and its effectiveness assessed.

  We believe that most companies do have policies about the qualifications and other attributes that they look for when slating candidates for election and addressing director succession matters. Many of these policies include a reference to diversity considerations. Particularly given the need to describe the effectiveness of these policies, companies may want to revisit their policies and succession and slating practices to ensure that the board's intentions are properly captured by the language and that the spirit of the policies is appropriately reflected in the board's actual practices.

<u>Legal Proceedings</u>

- The new rule expands the types of legal proceedings that must be reported if they involve directors, director nominees or executive officers, as well as the time period

covered (from five years to ten years). In both cases, the intention is to provide information relevant to an assessment of the competence and character of the persons in question. Companies should revise their D&O questionnaires and disclosure controls and procedures accordingly. For example, many companies now routinely do background checks on executive officers and director candidates, and that information should also be taken into account when preparing the disclosure.

- In brief, the additional legal proceedings are any federal or state judicial or administrative proceedings resulting from involvement in mail or wire fraud or that are based on violations of securities, commodities, banking or insurance laws and regulations, or any settlement of any of these actions, as well as disciplinary actions or orders imposed by a stock, commodities or derivative exchange or a self-regulatory organization.

- An instruction to the new rules clarifies that no disclosure of the settlement of any civil proceeding among private litigants is required.

<u>Board Leadership Structure and Role in Risk Oversight</u>

- A company must briefly describe the leadership structure of the board, including whether or not the same person serves as chief executive officer and chairman of the board. If the two roles are held by the same person, the company must also disclose whether it has a lead independent director and what specific role he or she plays in the leadership of the board. Many companies have elaborated the role of the lead director in greater detail, sometimes in response to voting policies of the proxy advisory firms. Companies that have not undertaken this effort and whose chief executive officer also serves as the chairman of the board should consider whether a lead director "job description" of this type would be an appropriate addition to their governance guidelines.

- The disclosure must address why the board leadership structure is appropriate, given the specific characteristics or circumstances of the company, and the extent of the board's role in the risk oversight of the company, including how the board administers its oversight function and the effect, if any, on the board's leadership structure. In the final rule, the SEC modified language in the proposal that called for disclosure about the board's role in risk "management," and correctly focused the final rule on the board's oversight function.

- The new rule provides significant latitude to companies in developing responsive disclosure. The disclosure should provide 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." Companies might consider disclosing whether the entire board performs the risk oversight role directly or whether these activities are distributed among board committees and, if the latter,

how these committees coordinate their work. The SEC also suggests that companies may want to address whether risk management personnel report as a matter of organizational hierarchy directly to the board or a committee, or otherwise provide the board or its committees with information about risk management.

Compensation Consultant Independence

- The SEC amended its proposed fee disclosure with respect to compensation consultants in ways that both broadened and narrowed the scope of the rule as proposed. In order to weed out immaterial information not helpful to investors and overly burdensome to produce, the SEC adopted a threshold for disclosure, extended the broad-based plan exception and also deleted the proposed requirement for a narrative description of non-executive compensation services. The rules also distinguish between situations where the compensation committee or board has its own compensation consultant (whether or not another compensation consultant is also engaged by the company or management), and those where only the company or management engages compensation consultant and the compensation committee or board does not have engage one separately.

- Companies must provide the following additional disclosure if, within the relevant fiscal year, (i) the compensation committee engaged a compensation consultant to provide recommendations or advice with respect to executive or director compensation and (ii) the consultant or its affiliates also provided additional services to the company or any of its affiliates for fees in excess of $120,000:

  - the aggregate fees paid for services relating to executive or director compensation;

  - the aggregate fees paid for the additional services;

  - whether engagement of the consultant or its affiliates for the additional services was made or recommended by management; and

  - whether the board of directors or the compensation committee approved the additional services.

- If management has a consultant to provide recommendations or advice with respect to executive or director compensation, the compensation committee or the board does not have its own compensation consultant, and management's consultant or its affiliates also provided additional services to the company or any of its affiliates for fees in excess of $120,000 during the most recent fiscal year, a company must disclose the aggregate fees paid for each of the executive compensation related services and the additional services.

- The adopting release clarifies that, to the extent a compensation committee has engaged its own consultant, no fee or other disclosure is required with respect to any executive compensation related services and/or additional services provided by a different compensation consultant engaged by management.

- In no event will any disclosure be required if a compensation consultant's role with regard to executive and director compensation is limited solely to (i) consulting with regard to non-discriminatory, broad based plans, participation in which is generally open to all salaried employees, or (ii) providing information not customized for the company or customized based on parameters not developed by, or discussed with, the compensation consultant.

- Many companies (especially those that use multi-service compensation consulting firms) have adopted policies designed to minimize the potential for conflicts of interest to arise if the compensation consultant or its affiliates provide other services to them. Companies may wish to review their policies to ensure that they address the issues highlighted by the new disclosure rules, or to consider adopting such a policy if one is not already in place. Companies should also modify their disclosure controls and procedures to track consultant fees potentially subject to the rules.

Form 8-K, Item 5.07

- Companies must report the results of a shareholder vote in new Item 5.07 of Form 8-K within four business days after the end of the meeting at which the vote was held. The reporting requirement also applies to matters submitted to a shareholder vote other than at a meeting (*e.g.*, the solicitation of any authorization or consent, other than a proxy at a shareholders' meeting).[8] Companies should update their disclosure controls and procedures accordingly.

- The required disclosure includes the meeting date and type (annual or special), the name of each director elected at the meeting, a brief description of other matters voted on and a statement of the number of votes case for, against or withheld, as well as the number of abstentions and broker non-votes for each matter. A separate tabulation for each director nominee is required. Item 5.07 disclosure must also report the terms of any settlement between the company and any other participant terminating a solicitation subject to Rule 14a-12(c), including the cost (or expected cost) to the company.

[8] Footnote 30 of the adopting release that implemented the four-business day deadline for most items in Form 8-K (Release No. 33-8400 (Aug. 23, 2004) (http://sec.gov/rules/final/33-8400.htm)) clarifies that the day of the triggering event is not included in calculating the deadline.

- The fact that voting results are preliminary does not obviate the need to file a report on Form 8-K, although the adopting release states that companies may provide cautionary disclosure about the preliminary nature of the results in that event. When final voting results are available, companies must amend the original report.

- The adopting release clarifies that the new requirement does not prevent companies from announcing preliminary voting results at a meeting before filing the report on Form 8-K, whether or not the meeting is webcast.

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Please contact any of the lawyers listed in the Corporate Governance or Employee Benefits section of our website (www.cgsh.com) or any of your other regular contacts at the firm for further information about the matters discussed above.

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