

### 4.3.6 Effects Of The New Compensation And Corporate Governance Rules On The 2010 Proxy Season

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On December 16, 2009, the U.S. [Securities and Exchange Commission](#) (SEC) adopted final rules that augment and revise the compensation and corporate governance disclosure requirements applicable to U.S. public companies. The new rules also require more rapid reporting on Form 8-K of shareholder voting results. The new rules, which amend [Regulation S-K](#) Items 401, 402 and 407, and add new Item 5.07 to Form 8-K, **are effective February 28, 2010**. Companies subject to the new rules should promptly incorporate compliance with these new rules into their proxy planning for 2010.

The SEC's release (No. 33-9089) issuing and discussing the new rules is available at [www.sec.gov/rules/final/2009/33-9089.pdf](http://www.sec.gov/rules/final/2009/33-9089.pdf) ([www.sec.gov/rules/final/2009/33-9089.pdf](http://www.sec.gov/rules/final/2009/33-9089.pdf)).

#### When Do the Rules Apply?

The adopting release provides that the new rules apply to any filings made on or after February 28, 2010, by companies with fiscal years ending after December 19, 2009. In addition, on December 22, 2009, the SEC Staff issued Compliance and Disclosure Interpretations (CD&I's), which are available at <http://sec.gov/divisions/corpfin/guidance/pdetinterp.htm> ([sec.gov/divisions/corpfin/guidance/pdetinterp.htm](http://sec.gov/divisions/corpfin/guidance/pdetinterp.htm)) and clarified the start date of these rules. These CD&I's provide the following clarifications:

- Preliminary proxy statements filed prior to February 28, 2010, must comply with the new proxy disclosure requirements if the related definitive proxy statement will be filed after February 28, 2010.
- Companies with fiscal years ending prior to December 20, 2009, are not required to comply with the new rules until filing their 10-Ks and proxy statements for fiscal year 2010. These companies may voluntarily apply the new rules at their discretion; however, if a company voluntarily complies with the new Summary Compensation Table and [Director](#) Compensation Table amendments, it must also comply with all other amendments that apply to the form filed.
- The new rules apply to [registration](#) statements filed for initial public offerings as well as registration statements on Form 10 if they are initially filed on or after December 20, 2009.
- The new 8-K disclosure requirements with respect to shareholders votes apply to any shareholder meeting or vote that takes place on or after February 28, 2010.

**Disclosure of Relationship Between Employee Compensation and Enterprise [Risk](#)**

The most challenging of the new rules is the requirement under Item 402(s) for companies to disclose how risk to the entire enterprise is factored into any policies and practices relating to employee compensation. Notably, this disclosure requirement goes beyond executive officers to include all employees. As a result, the SEC determined that this disclosure should not be included in the Compensation Discussion and Analysis (CD&A) portion of the proxy statement, which is focused on the compensation paid to the company's "named executive officers."

To the extent that risks arising from a company's compensation policies and practices for its employees are "reasonably likely to have a material adverse effect" on the company, the new disclosure is triggered, and the company will be required to discuss the company's policies and practices for striking the appropriate balance between encouraging appropriate risk taking and managing or mitigating excessive risk taking that jeopardizes the entire enterprise.

In keeping with the principles-based approach of the CD&A requirements, the SEC provides in the new rule the following non-exclusive list of situations that companies should focus on in determining whether the new risk disclosure is required:

- Business units that carry a significant portion of the company's risk profile
- Business units with compensation structured differently than other units within the company
- Business units that are significantly more profitable than other units within the company
- Business units in which compensation expense is a significant percentage of the unit's revenues
- Compensation policies and practices that vary significantly from the overall risk and reward structure of the company (for example, when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time)

To the extent the disclosure threshold is met, a company should address the following areas in its disclosure:

- The general design philosophy of the compensation policies and practices for employees whose behavior would be most affected by compensation incentives, including how such policies and practices relate to or affect risk taking by employees on the company's behalf and how they are implemented
- The company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices in awarding and paying compensation
- The relationship between the company's compensation policies and practices and the realization of risks resulting from the actions of employees in both the short term and the long term (*e.g.*, claw-back requirements and the imposition of holding periods)

- The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile
- Material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile
- The extent to which the company monitors its compensation policies and practices to ensure consistency with risk management objectives

**Practical Note:** The recent turmoil in the financial sector, including the failure of several financial institutions due to excessive risk taking, was the primary catalyst for this new disclosure rule. As proposed by the SEC in July 2009, the new rules would have required disclosure if the risks arising from the company's compensation policies and practices "may have a material effect" on the company. In response to comments, in its final rules the SEC modified the disclosure standard to require disclosure only when the company determines that such risks are "reasonably likely to have a material adverse effect" on the company. The SEC indicated the change was designed to elicit more meaningful and tailored disclosure for investors and avoid insignificant and unnecessary boilerplate disclosure.

In order to make an informed determination under this new rule, every reporting company, including non-financial institutions, must analyze its employee compensation policies and practices to determine the impact of such policies and practices on the company's risk profile. After such analysis, a company may conclude that the enterprise risks embodied in the company's compensation policies and practices are not "reasonably likely to have a material adverse effect on the company." The SEC noted that when analyzing whether the enterprise risks inherent in the company's compensation policies and practices are "reasonably likely" to have a "material adverse" effect on the company, a company could take into account any offsetting steps or controls implemented by the company to minimize the risk.

Each company is free to determine its own process for making its disclosure determination, the scope of which—covering all employees—goes beyond the traditional coverage of many compensation committees. In general, it is expected that compensation committees will share this responsibility with those responsible for risk assessment and management and those responsible for disclosure controls and procedures (*e.g.*, a disclosure committee). After determining the appropriate division of responsibility, companies should consider reviewing and updating the charters of the relevant committees to formally codify the process.

If a company concludes that the threshold for this new disclosure requirement is not met, such company is not required to include such an affirmative statement in its proxy statement and may simply omit the disclosure, which is usually advisable.

### **Changes to Summary Compensation Table and Director Compensation Table**

Under amended Regulation S-K Item 402, the following changes were made to the Summary Compensation Table and the Director Compensation Table:

- Companies must disclose the aggregate grant date fair value of stock and option awards granted during the year, computed in accordance with FAS 123R (now codified as FASB Accounting Standards Codification (ASC) Topic 718). This disclosure

replaces the current disclosure in the table, with respect to stock and option awards, of the dollar amount recognized for the year as an accounting expense under ASC Topic 718.

- Awards that are subject to performance conditions must be computed based upon the probable outcome of the performance conditions as of the grant date. A performance award will also require a footnote that discloses the grant date fair value assuming the achievement of the highest level of performance.
- Stock and option award disclosures that are included in the table for past years, including total compensation amounts, also must be revised in accordance with these new computation rules. If a named executive officer for 2009 was not an NEO for a previous year in the table, his or her compensation for the previous year must now be reported.

**Practical Note:** As a result of the new computations in stock and option awards, the identification of the named executive officers to be included in the table could change more frequently since one time large awards could cause an executive officer to be included as an NEO when in a typical year he would not have been included. The SEC has recommended that when a "new hire" or "retention" award of an executive officer results in another executive officer being dropped or excluded from the table, a company should consider including compensation disclosure for the other executive officer. The calculations for prior years for stock and option awards for the named executive officers will need to be recalculated in accordance with the new rules for the named executive officers included in the 2010 summary compensation table, but the company does not need to re-determine who qualified as named executive officers for prior years based on recomputed total compensation.

## **Disclosure on Director Qualifications, Experience and Diversity**

### **DIRECTORS QUALIFICATIONS**

Amended S-K Item 401 requires disclosure of the particular experience, qualifications, attributes or skills that led the Board to conclude that the person should serve as a director for the company at the time of the filing, in light of the company's business and structure. This disclosure must be made each year for all director nominees and current directors, even if the directors are not up for election. Disclosure about a director's qualifications to serve on committees is not required; however, if a director was appointed or nominated because of a particular qualification, attribute or experience related to a specific board committee, then this should be disclosed under the amended rule.

**Practical Note:** Companies should consider adopting a new Board resolution as part of their routine annual corporate governance resolutions reflecting the Board's consideration of the bases for and approval of the disclosure regarding directors' qualifications. Also, companies should consider amending their officer and director questionnaires to obtain information regarding a director's or nominee's experience, qualifications, attributes and skills. A marked version of the McDermott Will & Emery 2010 Model Director and Officer Questionnaire reflecting these and other recommended changes as noted below is available at: [www.mwe.com/info/pubs/Redlined\\_DO\\_Questionnaire.pdf](http://www.mwe.com/info/pubs/Redlined_DO_Questionnaire.pdf) ([www.mwe.com/info/pubs/Redlined\\_DO\\_Questionnaire.pdf](http://www.mwe.com/info/pubs/Redlined_DO_Questionnaire.pdf)).

### **DIRECTOR PUBLIC COMPANY EXPERIENCE**

Amended S-K Item 401 requires disclosure of any public company or investment company directorships that have been held by a director or director nominee during the past five years. This differs from the current rule, which requires disclosure of directorships currently held.

**Practical Note:** Companies should update their officer and director questionnaires to ask about all applicable directorship positions held during the past five years.

## **LEGAL PROCEEDINGS**

Amended S-K Item 401(f) requires the disclosure of legal proceedings involving directors, director nominees and executive officers for the last ten years, rather than the current five-year requirement. In addition, the amendment expands the types of legal proceedings requiring disclosure to include proceedings based on violations of securities, commodities or laws and regulations respecting financial institutions or insurance companies (including settlements of such actions), proceedings involving mail or wire fraud, and disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

**Practical Note:** Companies should amend their officer and director questionnaires to ask about legal proceedings occurring within the last ten years and to include the new types of legal proceedings covered by the rule.

## **DIRECTOR DIVERSITY**

Amended S-K Item 407(c) requires disclosure regarding the following:

- Whether or how the nominating committee (or Board) considers diversity when evaluating a nominee
- If the nominating committee (or Board) has a policy to consider diversity when identifying director nominees, how the policy is implemented, and how the committee (or board) evaluates the effectiveness of the policy

The SEC left the definition of "diversity" up to each company and noted that diversity need not apply only to racial or gender diversity but could also apply to differences of viewpoint, professional experience, education, skill, and other individual qualities and attributes that contribute to board heterogeneity.

**Practical Note:** Boards or nominating committees should consider adopting a diversity policy and assessing the role of diversity in evaluating director nominees.

## **Disclosure of Board Leadership Structure and Board Role in Risk Oversight**

### **BOARD LEADERSHIP STRUCTURE**

Amended Item 407 of Regulation S-K requires companies to "briefly describe" the company's board leadership structure (*e.g.*, whether the positions of CEO and Chairman are combined or split) and why the company believes that such a structure is "appropriate given the specific characteristics or circumstances of the company." If the company has a

combined Chairman/CEO, then the company must also provide disclosure about the specific role of the Lead Independent Director in the Board leadership structure.

**Practical Note:** To the extent not already in effect, companies with a combined Chairman/CEO and Lead Independent Director leadership structure should consider adopting corporate governance guidelines specifying the role of the Lead Independent Director in such a leadership structure.

## **ROLE OF BOARD IN RISK OVERSIGHT**

Amended Item 407 of Regulation S-K also requires companies to disclose the extent of the Board's role in the risk oversight of the company (*e.g.*, how the Board administers its oversight function). In its adopting release, the SEC clarified that it intended to elicit disclosure regarding the internal mechanics of how a Board is made aware of the material financial, operational and reputational risks faced by its company. Many companies assign responsibility for financial and legal risk oversight to a specific Board committee, such as the audit committee. The corporate governance standards of the New York Stock Exchange already required audit committees of companies listed on that exchange to have responsibility, at a minimum, for guidelines and policies governing the process by which risk assessment and management is undertaken.

**Practical Note:** Companies should consider how the Board's risk oversight role is currently discharged and, if the company believes changes are required, update the agendas for upcoming Board and committee meetings, as appropriate, to clarify the Board's risk oversight process prior to the preparation of their next proxy statement.

## **Disclosure of Fees Paid to Compensation Consultants**

Under amended Item 407 of Regulation S-K, companies will be required to disclose, under certain circumstances, the aggregate annual fees paid to outside compensation consultants for executive and director compensation consulting services and for non-executive compensation consulting services. The new rule is in addition to the existing rule which requires that companies describe the role of compensation consultants in determining or recommending executive and director compensation; however, as discussed below, even the scope of that existing rule was narrowed by the amended rules.

In crafting the new disclosure rule, the SEC focused on engagements of compensation consultants that are subject to a potential conflict of interest. Going forward, the following will apply:

- No disclosure relating to the role of a compensation consultant will be required when the compensation consultant's role is limited to consulting on broad-based plans that do not discriminate, in scope, terms or operation, in favor of executive officers or directors.
- No disclosure relating to the role of a compensation consultant will be required when the compensation consultant's role is limited to providing information (but not providing any advice on such information) that either is not customized for a particular company or that is customized based on parameters that are not developed by the compensation consultant (*e.g.*, survey information).

- If the compensation consultant was engaged by the compensation committee to provide advice on executive or director compensation, and such compensation consultant also received more than \$120,000 from the company for non-executive compensation services during the last completed fiscal year, disclosure of the following are required: aggregate fees paid to the consultant for both the executive compensation advisory services to the compensation committee and the non-executive compensation services to the company; information as to whether the decision to engage the compensation consultant for the non-executive compensation services was made or recommended by management; and information as to whether the compensation committee or Board approved such engagement.
- If the compensation committee has not engaged its own compensation consultant, but management has engaged a compensation consultant to provide to the company executive compensation advisory services, and such compensation consultant also received more than \$120,000 from the company for non-executive compensation services during the last completed fiscal year, disclosure of the following is required: aggregate fees paid to the consultant for both the executive compensation advisory services and the non-executive compensation services provided to the company.

**Practical Note:** Where a compensation committee's compensation consultant provides non-executive compensation services to the company, or where management engages its own compensation consultant, and the compensation committee does not engage a separate compensation consultant, companies should calculate the amount of fees paid to such compensation consultant during 2009 for both executive compensation advisory work and non-executive compensation services to determine whether the \$120,000 disclosure threshold has been triggered. In addition, in light of the new disclosure requirement, companies that have not already done so should consider adopting pre-approval policies similar to those in place for outside auditor engagements, in order to give the compensation committee an opportunity to review and approve all company engagements of compensation consultants.

### **Reporting Shareholder Voting on Form 8-K**

The new rules also created a new Item 5.07 to the Current Report on Form 8-K, to disclose on that form (rather than on Forms 10-Q or 10-K) the results of shareholder votes within four business days after the end of the meeting at which the vote was held. If votes are not certified within that time period, companies must disclose the preliminary voting results within the four business day period and then amend the 8-K within four business of the final results. An 8-K is also required to disclose shareholders votes that occur outside of a meeting (such as a consent solicitation).

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