SEC Adopts Rules Related to Executive Compensation and Corporate Governance Disclosure

At an open meeting yesterday, the Securities and Exchange Commission (SEC) voted 4-1 to adopt amendments to the disclosure requirements related to executive compensation and other corporate governance matters in proxy and information statements, annual reports and registration statements. The adopted amendments will require disclosure of

- compensation policies as they relate to risk,
- the potential conflicts of interest of compensation consultants,
- director and nominee qualifications,
- board leadership structure, and
- diversity policies relating to board membership.

The SEC also adopted amendments to require the disclosure of stockholder voting results in a Form 8-K, and to revise the disclosure of stock and option awards in the summary compensation tables and director compensation tables.

The effective date for the amendments is February 28, 2010. The Staff has yet to clarify, but it appears that companies will have to comply with all the new rules for the upcoming annual report and proxy season, as well as any other relevant filings, after February 28, 2010. The change in the disclosure relating to the summary compensation tables will be required by companies providing Item 402 disclosure for fiscal years ending on or after December 20, 2009.

The SEC also adopted amendments to the investment adviser custody rule (Rule 206(4)-2) under the Investment Advisers Act of 1940 and related forms and rules. Alston & Bird will distribute a separate advisory regarding these changes.

Amendments to Compensation-Related Disclosure

Compensation and Risk

The adopted amendments will expand compensation disclosure by requiring a company to discuss compensation policies and practices for all employees, including non-executive officers, and to discuss how these overall compensation policies affect the company’s risk and management of that risk. This disclosure, however, will only
be required in situations where such risks are “reasonably likely to have a material adverse effect on the company.”

This standard, revised from the original proposal, is intended to parallel the requirement for Management Discussion and Analysis disclosure of known trends and uncertainties, and avoid boilerplate language in risk-related disclosure. The company will not be required to 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 on the company.

**What should the company consider when determining if disclosure is necessary?**

The final rule includes non-exclusive illustrative examples to provide guidance to companies regarding the types of issues that the SEC believes may be appropriate for discussion and analysis.

First, the rule provides examples of situations where the SEC believes a disclosure obligation may be triggered with compensation policies and practices:

- at a business unit of the company that carries a significant portion of the company’s risk profile,
- at a business unit with compensation structured significantly differently than other units within the company,
- at a business unit that is significantly more profitable than others within the company,
- at a business unit where the compensation expense is a significant percentage of the unit’s revenues, and
- that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

Second, the rule provides examples of the type of discussion if disclosure is required:

- the general design philosophy of the company’s compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk-taking by those employees on behalf of the company, and the manner of their implementation;
- the company’s risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;
- how the company’s compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods;
- the company’s policies regarding adjustments to its compensation policies and practices as a result of changes in its risk profile; and
- the extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.
The SEC cautions that the examples serve only to identify the types of disclosure and discussions that may be applicable, but that companies must assess the examples in light of the company’s particular situation. For example, if a company has a compensation practice that encourages certain risks in certain groups of the company, but another part of the company works to help mitigate that risk, the company can consider whether these two functions off-set each other. If the company makes such a finding, then disclosure of such a compensation practice may not be required.

**Will this disclosure be in the CD&A?**

No. Although originally proposed to be included in a company’s Compensation Discussion and Analysis (CD&A), in response to public comment, the SEC determined that including such broad disclosure in the CD&A would likely cause confusion. The new disclosure will now be required pursuant to a new Item 402(s) of Regulation S-K rather than as part of CD&A, which smaller reporting companies do not have to provide. Smaller reporting companies will not be required to provide this new disclosure.

**Stock and Option Awards**

The SEC adopted, substantially as proposed, amendments to the disclosure rules relating to the value of stock and option awards. Under the amended rules, disclosure of stock and option awards in the summary compensation and director compensation tables will no longer be based on the expense recognized during the year for financial statement reporting purposes. Instead, disclosure will be based on the aggregate fair value of the awards on the date they were granted, computed in accordance with Financial Accounting Standards Board’s Accounting Standards Codification Topic 718 (formerly known as FAS 123R).

The SEC revised its original proposal in response to comments that the proposed amendments would have created disincentives for the use of performance-based awards or resulted in inflated reporting. Under the amendment as adopted, the amount to be included in the tables is the value at the grant date based on the probable outcome of the performance conditions as of the grant date, instead of the maximum potential value of the award. The maximum potential value will be required to be disclosed in a footnote to the table. The SEC reasoned that this value would better reflect how the compensation committee takes performance-contingent vesting conditions into account in granting such awards.

Companies will also have to re-compute the value of stock and option awards for all fiscal years required to be included in the table based on this new grant-date fair value standard, which will allow a ready comparison over the three-year period (and this should be relatively easy to do, because these values were previously required to be calculated and provided on an award-by-award basis in the Grants of Plan-Based Awards table for prior years). Companies will not be required to include different named executive officers in any preceding fiscal year based on the re-computation of the total compensation for those years pursuant to the amendment. The amended rules regarding valuation of stock and option awards will be required when companies provide Item 402 disclosure for a fiscal year ending on or after December 20, 2009.

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1 Under the current CD&A rules, disclosure of risk considerations is already required if such considerations are a material part of the company’s compensation policies or decisions for named executive officers.
Compensation Consultants

As a result of the adopted amendments, companies will be required to disclose the fees paid for the services of compensation consultants (or their affiliates) who play a role in determining the amount and form of compensation for executives and directors, if those consultants (or their affiliates) also provided other services to the company in excess of $120,000 during the company’s last completed fiscal year. When that is the case, the aggregate value of the compensation-related services and the aggregate value of the other non-compensation related services must be disclosed. The rule will not require the disclosure of the nature of the additional services, although a company may include a description of any additional non-executive compensation consulting services where such information would facilitate investor understanding of the existence or nature of any potential conflict of interest.

Does it matter if the compensation consultant has been retained by the board?

Yes. In addition to the disclosure above, in cases where the compensation consultant has been retained by the board, the company will be required to disclose whether the decision to engage the compensation consultant was made or recommended by management and whether the board or compensation committee approved the engagement.

Are there exceptions?

The amendments, as adopted, include an exception for disclosure in situations where compensation consultants provide only broad-based advice, such as advice related to 401(k) plans or health insurance benefits, or survey information that is not customized or tailored to the company by the consultant.

In addition, recognizing that concerns about potential conflicts are mitigated if the board and management have retained separate compensation consultants, where the board has retained its own compensation consultant, no disclosure of fees paid to other compensation consultants is required, even if management's consultants provide non-compensation related services to the company.

Amendments to Corporate Governance Related Disclosure

Director Qualifications

The SEC adopted amendments expanding the disclosure requirements regarding the qualifications that led to the nomination of directors and nominees, past directorships held by directors and nominees, and the time frame for disclosure of legal proceedings involving directors, nominees and executive officers.

In what was referred to as the “person-by-person approach” at the open meeting, the SEC adopted amendments requiring companies to provide detailed disclosure every year with respect to the particular experiences, qualifications, attributes or skills of each director or nominee that led to the board’s decision to nominate that person and the reasons why that person should serve as a director of the company at the time that a relevant filing is made with the SEC. This means that the disclosure will need to be included even if that person is not up for reelection in that year. The final rules do not specify particular information that must be disclosed, thus giving companies flexibility

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2 This additional disclosure would also apply to nominees put forward by another proponent in its proxy materials.
to include information most relevant to them. In the adopting release, the SEC noted that if particular skills, such as risk assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board or proponent to conclude that the person should serve as a director, this should be disclosed. Companies will also be required to disclose any directorships held by each director or nominee at any public company during the previous five years, in addition to those currently held.

In an effort to provide insight into director character and competence, the new rules require that companies disclose specified legal proceedings involving directors, director nominees and executive officers for the past 10 years, instead of five years (as required under the existing rules). The SEC also expanded the original proposal to require disclosure of additional types of legal proceedings, including those related to (1) involvement in mail or wire fraud, or fraud in connection to any business entity; (2) any judicial or administrative action, or public settlement of such action, based on a violation of the federal or state securities, commodities, banking or insurance laws or regulations; and (3) any disciplinary action taken by a self-regulatory organization. The rule includes an instruction clarifying that disclosure will not be required for settlements of private actions under these amendments.

**Board Diversity**

Although the proposing release included only a request for comment on disclosure of board diversity, the SEC incorporated this concept into the final rules. As adopted, a company will be required to disclose whether and how its nominating committee considers diversity in identifying nominees or directors. Under the rules, diversity is not defined, though the SEC staff noted at the open meeting that a company can define diversity as broadly or as narrowly as it desires, but it will have to disclose its definition of diversity. The adopting release notes that some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. If a nominating committee or board has a policy with regard to the consideration of diversity in identifying director nominees, the amendments will require disclosure of how this policy is implemented and how the committee or board assesses the effectiveness of such a policy.

**Board Leadership Structure**

A company will be required to disclose its board leadership structure, including whether and why it has chosen to combine or separate the principal executive officer and board chair positions, and why it believes it is the most appropriate leadership structure for the company as of the time of the disclosure. If the company has a combined CEO and board position, the company will also have to disclose whether it has an independent lead director, why it has an independent lead director and the specific role that such a lead director plays in the leadership of the company. A registered investment company will be required to disclose whether the board chair is an independent director, and if not, whether it has an independent lead director and what role such person plays in the leadership of the fund. The adopting release highlights that these rules are intended to enhance transparency and not to require the separation of these positions or to imply that one leadership structure is preferable to another.

**Board Oversight of Risk**

Additional disclosure in the proxy and information statements regarding the extent of the board’s role in the risk oversight of the company will also be required. Specifically, the amendments will require disclosure of how the
board administers its oversight function and the effect this has on the board’s leadership structure. Disclosure required under this amendment, for example, would include whether such oversight is conducted by the whole board, through the audit committee or through a separate committee tasked with risk oversight. If the oversight is through more than one committee, companies are expected to disclose how the committees perform this function together. Additionally, this disclosure might also address whether the persons who oversee risk management report directly to the board or some other board committee.

**Election Results**

To effectuate more timely disclosure of annual meeting voting results, the new amendments will require a company to disclose the results of a shareholder vote on a Form 8-K that is filed within four business days after the end of the meeting at which the vote was held. If final results are not available, a company will still need to file a Form 8-K detailing preliminary voting results within four business days. Once final results become available, the company must then file an amended Form 8-K/A within four business days.

**Considerations For Revised Disclosure**

Due to the adoption of the amendments to the proxy disclosure rules, most companies will be required to revise their proxy disclosure for the upcoming proxy season. In this regard, the following actions should be taken by companies in preparing revised disclosure:

- Review compensation policies and practices for both executive officers and employees, and discuss with the compensation committee to determine the impact on the company’s overall risk; develop procedures to evaluate risks associated with compensation policies.

- Recalculate compensation tables for the proxy statement based upon the aggregate fair value of stock and option awards on the grant date.

- Identify and quantify any services that compensation consultants perform for the company, and consider whether and what policies should be implemented to approve and monitor additional services performed by compensation consultants to avoid actual or potential conflicts of interest.

- Determine whether the nominating and governance committee should adopt a diversity policy for directors if the company has not already done so. If a policy is in place, evaluate the effectiveness and implementation of such policy.

- Evaluate the company’s current leadership structure and why such a structure is appropriate for the company; develop leadership structure evaluation policies.

- Review the board’s role in risk assessment and oversight, and consider whether it has the appropriate structure and processes in place to oversee major risks; develop risk assessment procedures or supplement existing procedures as necessary.

- Revise existing D&O questionnaires to gather additional information about directors’ qualifications, skills and experiences, as well as additional biographical data; implement board qualification assessment procedures.
• Discuss with the company’s transfer agent the new timeline for reporting voting results to ensure the new disclosure deadline can be met.

Proxy Solicitation

In addition to the disclosure enhancements, the proposing release included several provisions to clarify certain proxy rules regarding shareholder communications and voting. These proposed amendments would have clarified rules related to unmarked proxies, substantial interest, short slates, conditions imposed by soliciting parties, and the availability of the identity and interests of solicitation participants. Because the SEC continues to consider the proposed amendments related to shareholder proxy access for the nomination of directors, the SEC delayed consideration of these amendments until they may be considered with that larger proposal.

Outlook

In her opening statement,3 Chairman Schapiro stated that although the new amendments will help shareholders exercise their “oversight responsibility,” the SEC Staff continues to work on a comprehensive review of the infrastructure supporting the proxy process, including the role of proxy advisors. Chairman Schapiro also reiterated her intention to bring final shareholder director nomination rules before the full Commission early next year.
