

December 29, 2009

SEC Amends Disclosure Rules for Executive Compensation and Corporate Governance

The U.S. Securities and Exchange Commission (SEC) recently adopted amendments to its rules affecting disclosure of executive compensation and corporate governance matters.¹

Summary of Key Changes

The executive compensation amendments require disclosure of:

- The relationship between compensation practices and risk management, if the risks arising from compensation practices are reasonably likely to have a material adverse effect on the company
- Stock and option awards at the aggregate grant date fair value in the fiscal year granted, rather than the dollar amount recognized each fiscal year for financial statement purposes
- Fees paid to compensation consultants and their affiliates in certain circumstances

The corporate governance amendments require disclosure of:

- The qualifications of directors and nominees, including directorships held by directors and nominees in the past five years, and legal actions in the past ten years involving directors, nominees and executive officers
- How diversity is considered in the director nomination process
- The board's leadership structure (e.g., separation of chairman and CEO roles)
- The board's role in the oversight of risk
- Shareholder voting results on Form 8-K within four business days after the vote

Effective Dates

The amendments will generally apply to disclosure for the 2010 proxy season. If a company's fiscal year ends on or after December 20, 2009, its Form 10-K and proxy statement filed on or after February 28, 2010 must meet the new disclosure requirements.

Executive Compensation

Compensation-Related Risk Management Disclosure

The amendments require a company to discuss its compensation policies and practices that are reasonably likely to have a material adverse effect on the company. If a company has policies and practices that mitigate or balance those incentives, they could be considered in deciding whether risks arising from compensation policies and practices are reasonably likely to have a material adverse effect. The "material adverse effect" standard is intended

¹ The SEC adopted the rules on December 16, 2009, in amendments to Regulation S-K. See Release Nos. [33-9089](#), 34-61175, and IC-29092.

to avoid unnecessary discussion of compensation policies that enhance a company's business interests by encouraging innovation and appropriate levels of risk-taking. This disclosure applies for all employees, not only named executive officers. Smaller reporting companies are not required to provide this new disclosure.

The SEC gives some examples of compensation policies and practices that may be reasonably likely to have a material adverse effect on a company:

- a business unit of the company carries a significant portion of the company's risk profile
- compensation at a business unit is structured significantly differently than compensation at other business units
- a business unit is significantly more profitable than others
- compensation expense is a significant percentage of a business unit's revenues
- the company has in place compensation policies or practices 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 arising from the task extend over a significantly longer time.

The SEC also provides some examples of the issues that a company may need to discuss if its compensation policies and practices are reasonably likely to have a material adverse effect on the company:

- the general design philosophy of and manner of implementing the company's compensation policies for employees whose risk taking on behalf of the company would be most incentivized by those policies
- the company's risk assessment or incentive considerations in structuring its compensation policies or in awarding and paying compensation
- how the company's compensation policies relate to the realization of risks resulting from the actions of employees in both the short-term and long-term, such as through policies requiring claw backs or imposing holding periods on equity grants
- the company's policies regarding adjustments to its compensation policies to address changes in its risk profile
- material adjustments the company makes to its compensation policies or practices as a result of changes in its risk profile
- the extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

Each company should assess the SEC's examples in light its particular situation. The SEC does not want generic or boilerplate disclosure, such as statements that "incentives are designed to have a positive effect," or "compensation levels may not be sufficient to attract or retain employees with appropriate skills."

Stock and Option Award Values

The amendments change how companies must value the dollar amounts for stock and option awards that are disclosed in the proxy statement's Summary Compensation Table and the Director Compensation Table, and that are included in the total compensation calculation. The value of these awards must be reported based on the

aggregate grant date fair value.² Those values previously were based on the dollar amount recognized for financial reporting purposes for each fiscal year.

Named Executive Officers

Total compensation is the basis for determining which executive officers must be named in the proxy statement, in addition to the principal executive officer and principal financial officer. The amendment may affect who must be named executive officers in the proxy statement. A large, one-time “new hire” or “retention” grant to a lower paid executive officer could place that person’s total compensation above another executive officer whose total compensation would otherwise require him or her to be named as an executive officer in the proxy statement. Companies can, therefore, include supplemental disclosure for an additional executive officer if he or she would have been included in the proxy statement but for a large one-time award to another executive officer.

Performance Awards

The amendments also clarify that performance awards (those awards that are subject to performance conditions as defined in the Glossary to FASB ASC Topic 718) should be disclosed in the Summary Compensation Table, Grants of Plan-Based Awards Table and Director Compensation Table based on the probable outcome of the performance conditions as of the grant date. The amendments add instructions to these tables to clarify that this amount will be consistent with the grant date estimate of compensation cost to be recognized over the service period, excluding the effect of forfeitures. Companies must also provide footnote disclosure to the Summary Compensation Table and Director Compensation Table of the maximum value of the award assuming the highest level of performance conditions that is probable.

The required disclosure will be of awards granted during the year, even if such grants are for service during a different year. Companies should, however, continue to disclose in their proxy statement Compensation Discussion and Analysis (CD&A) section any decisions to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of named executive officers’ compensation for the prior fiscal year, and consider supplemental tabular disclosure where it facilitates understanding.

Effect on Table Presentation

Companies providing executive compensation disclosure for a fiscal year ending on or after December 20, 2009 must present re-computed stock and option awards disclosure for each preceding fiscal year required to be included in the Summary Compensation Table. This re-computed disclosure should be based on the individual award grant date fair values reported in the applicable year’s Grants of Plan-Based Awards Table, except that awards with performance conditions should be recomputed to report grant date fair value based on the probable outcome as of the grant date. If a person who would be a named executive officer for the most recent fiscal year (2009) also was disclosed as a named executive officer for 2007, but not for 2008, the named executive officer’s compensation must be reported for each of those three fiscal years with recomputed stock and option award values. The SEC is not, however, requiring companies to include different named executive officers for any preceding fiscal year based on re-computing total compensation for those years pursuant to the amendments or to amend previously filed executive compensation disclosure.

Compensation Consultants

Many companies engage compensation consultants to advise the board of directors on executive and director compensation, to design and implement incentive plans, and to provide information on industry and peer group pay

² This amount must be computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation—Stock Compensation (“FASB ASC Topic 718,” formerly FAS 123R).

practices. Compensation consultant engagements often go beyond providing those services for the board. The same compensation consultants, or their affiliates, may be retained by management to provide additional services, such as benefits administration, human resources consulting and actuarial services. This creates a potential for a conflict of interests at the consultant. The amendments require disclosure about fees and the retention of compensation consultants if they or their affiliates also provide the other services to the company and the fees for those other services exceed \$120,000 in a fiscal year. In that case, the company must disclose:

- the aggregate fees paid for services provided to either the board, compensation committee or other person performing the equivalent functions or the company related to executive and director compensation
- the aggregate fees paid for any non-executive compensation consulting services provided by the compensation consultant or its affiliates
- whether the decision to engage the compensation consultant or its affiliates for non-executive compensation consulting services was made or recommended by management
- whether the board, compensation committee or other persons performing the equivalent functions have approved the non-executive compensation consulting services.

No such disclosure is required where the board retains a separate compensation consultant. The amendments exempt from disclosure consultation services involving only broad-based non-discriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant.

Corporate Governance Disclosure

Director and Nominee Qualifications

The amendments require expanded disclosure of the qualifications of directors and nominees. Companies must disclose, for each director and nominee, the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director. This disclosure supplements the current disclosure required about the specific minimum qualifications and specific qualities or skills considered by the nominating committee in nominating directors. The amendments do not specify what information must be disclosed, so companies have flexibility in determining what information should be disclosed about each director's or nominee's skills, qualifications or particular areas of expertise. The amendments also require disclosure of any public company directorships held by each director and nominee during the previous five years, as compared to the existing two-year look back.

The amendments add disclosure for new types of legal actions involving a company's directors, nominees and executive officers. They also lengthen to ten years, as compared to the existing five-year look back, the time frame for disclosure of all legal proceedings involving directors, nominees and executive officers. The following additional legal proceedings must be disclosed for directors, nominees and executive officers:

- any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity
- any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement (excluding a settlement of a civil proceeding among private parties) to such actions

- any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Diversity Considerations in the Director Nomination Process

The amendments require disclosure about how the nominating committee (or board) considers diversity in identifying nominees for director. If the company has a diversity policy in identifying director nominees, it must disclose how the policy is implemented and how the nominating committee (or the board) assesses the effectiveness of the policy. The SEC has not defined “diversity” for this purpose. Companies are free to define diversity as they deem appropriate. Thus, diversity may be considered expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity. Companies may also choose to focus on diversity concepts such as race, gender and national origin.

Company Leadership Structure

The amendments require disclosure of, and the reasons for, the leadership structure of a company's board. A company must disclose whether and why it has chosen to combine or separate the principal executive officer (CEO) and board chairman positions, including why it believes this structure is the most appropriate structure at the time of the filing. If the CEO and board chairman roles are combined, the company must disclose whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company.

Board Role in Risk Oversight

The amendments require disclosure of the board's role in the oversight of risk, such as credit risk, liquidity risk and operational risk. The disclosure should include information about how the company perceives the board's role in risk management and the relationship between the board and senior management in managing material risks. Companies have flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee. Companies may choose to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee, or how the board or committee otherwise receives information from those individuals.

Reporting of Voting Results on Form 8-K

The amendments require disclosure of shareholder voting results on Form 8-K within four business days after the end of the meeting at which the vote was held. Companies must disclose preliminary voting results within four business days after the end of the meeting, and must disclose final results within four business days after the final results are known. If final voting results are known within four business days after the end of the meeting, they may be disclosed in lieu of preliminary results.

Effective Dates

The SEC issued Compliance and Disclosure Interpretations (C&DIs) to answer questions about the effectiveness of the new rules.³ If a company's fiscal year ends on or after December 20, 2009, its Form 10-K and proxy statement filed on or after February 28, 2010 must comply with the new proxy disclosure requirements. If the Form 10-K is filed before February 28, 2010 and the proxy statement after that date, the proxy statement must comply

³ <http://sec.gov/divisions/corpfin/guidance/pdetinterp.htm> (December 22, 2009)

with the new requirements. A preliminary proxy statement filed before February 28, 2010 must comply with the new requirements if the definitive proxy statement is expected to be filed after that date. Voluntary compliance with the amendments is permitted.

Any shareholder meeting that takes place on or after February 28, 2010 is subject to the new Form 8-K reporting requirement, even if the proxy statement was mailed before that date and was not subject to the amendments.

Recommendations

Companies should consider taking the following steps now to comply with the new rules for the 2010 proxy season:

Executive Compensation

- consider what the company's disclosure will look like under the new amendments and draft it well in advance, so that issues and questions can be raised and resolved, and necessary information obtained, in a timely manner
- review whether the company's overall compensation policies and practices for employees create risks that are reasonably likely to have a material adverse effect on the company, and consider implementing modifications or measures to address the adverse effects of those incentives
- determine whether the proposed change in the method of reporting the value of stock and option awards will change the identification of the company's named executive officers and begin to recalculate the amounts for prior years that will be reported in the appropriate tables
- determine whether disclosure about the fees paid to compensation consultants and their affiliates will be required, and begin to compile the fee information and draft the required disclosure
- consider implementing or updating written policies regarding compensation consultant independence and approval of the provision of additional services by compensation consultants who are engaged with regard to executive officer or director compensation

Corporate Governance

- update director and officer questionnaires and consider whether any additional procedures are necessary in order to provide the additional disclosure regarding the qualifications of directors and nominees, past directorships held by directors and nominees and legal proceedings involving directors, nominees and executive officers during the past ten years
- determine who is going to assess the qualifications of directors and nominees (e.g., the board, the nominating committee, the director him or herself)
- draft the required disclosure regarding board diversity and consider implementing or updating company policies related to diversity after determining what the company considers to be "diversity"
- review the composition and structure of the board, confirm that it is the best composition and structure for the company, and consider and begin to draft the disclosure to explain such determination;
- consider appointing a lead independent director if the chief executive officer is also the chairman of the board

- consider formalizing in writing the role of the lead director (e.g., in the company's corporate governance guidelines)
- review the board's role in the company's risk oversight process and consider whether any changes should be made
- revise your disclosure controls and procedures to ensure that the shareholder vote results and other information required by the new rules is recorded, processed, summarized and reported in a timely manner.

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