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A legal update from Dechert's Corporate Finance and Employee Benefits and Executive Compensation Groups

SEC Adopts New Proxy Disclosure Rules

The Securities and Exchange Commission on December 16, 2009 adopted final rules intended to enhance disclosure regarding corporate governance and compensation matters in proxy statements and other reports.[1] The new rules focus on disclosure regarding risk and risk oversight, director and director nominee qualifications, board leadership structure, potential conflicts of interest of compensation consultants, and other compensation matters.

While the final rules are in most respects substantively the same as were proposed by the Commission in July, there have been a number of changes made in response to comments, notably, clarification of the applicable standards for disclosure of risk-related compensation policies and disclosure of the extent to which diversity (broadly defined) figures into decisions concerning the composition of the Board.

The new rules are effective February 28, 2010, and are generally applicable to the upcoming 2010 proxy season.

Risk and Risk Oversight

The Role of the Board

With a view to providing greater transparency of corporate risk, the SEC is now requiring companies to describe the role of the board of directors in the oversight of the material risks facing the company. Risks facing a company might include, for example, credit risk, liquidity risk and operational risk. The SEC has reiterated its view that disclosure concerning the board's role in the oversight of a company's risk management processes is important to an investor's understanding of how a company perceives the role of the board and the board's relationship with executive management in managing the company's principal risks. Specifically, the new rules require a company to disclose the extent of the board's role in risk oversight, how the board administers its oversight role, and the effect of this on the board's leadership structure. In adopting these rules, the SEC has recognized that risk oversight and not risk management more appropriately describes the relevant board function, and that the board has the flexibility to determine how to administer such function (whether through the entire board or a separate committee).

Compensation as it Relates To Risk

With a view to exposing risks that may arise from how a company compensates and incentivizes its employees, the new rules require a company to provide narrative disclosure of its compensation policies and practices for all employees (including non-executive officers) as they relate to risk management practices and risk-taking incentives. Importantly, the disclosure is only required if compensation policies are "reasonably likely to have a material 'adverse' effect on the company," a higher standard than was originally proposed. The "reasonably likely" disclosure threshold is the same as is used in Management's Discussion and Analysis (MD&A) risk-oriented disclosure of known trends and uncertainties that are material to a company's business. The new rules detail certain situations which potentially

[1] The new rules can be found at http://www.sec.gov/rules/final/2009/33-9089.pdf.

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could trigger such disclosure.[2] In determining whether risks arising from compensation policies and practices are reasonably likely to have a material adverse effect on a company, a company may consider policies or practices that mitigate or balance incentives. The disclosures with respect to the relationship between risk and compensation policies are required to address policies that are applicable to a broader group of employees than just the named executive officers. As a result, and unlike the original proposal, these disclosures are to be made outside of the Compensation Discussion and Analysis (CD&A); and, therefore, specific approval of the Compensation Committee will not be required. In addition to describing the practices and policies, disclosure will be required of the extent to which such policies and practices are monitored to determined whether risk management objectives are being met.

Governance and Director Qualifications

Background and Qualifications of Directors and Nominees

Companies must now disclose the specific experience, qualifications, attributes, or skills that lead the board to conclude that an individual (whether a current director or a board nominee) should serve as a director of the company at the time the disclosure is made. The same disclosure is required for any director nominees put forward by proponents soliciting proxies. The new disclosure will be required for all board members and nominees, regardless of whether such director is currently up for reelection. The SEC is requiring that companies make these disclosures annually because entire board composition is important to voting decisions.

In addition, the existing requirement to disclose any directorships held by directors or board nominees at public companies or registered investment companies has been expanded to include directorships held during the past five years (even if the director is no longer serving on such board). Also, the existing requirement to disclose any legal proceedings during the past five years involving directors, nominees, and executive officers has been expanded to cover legal proceedings during the past 10 years.[3]

Diversity

Companies must now disclose whether and how the nominating committee or board considers diversity when selecting board nominees. Additionally, if the nominating committee or board has a diversity policy for considering board nominees, a company must describe how the policy is implemented and how its effectiveness is assessed. In adopting this new disclosure requirement, the SEC purposely did not define "diversity," and noted that diversity may be given a broad definition for these purposes. Companies may define diversity in different ways—differences of viewpoints, professional experience, education, and skills may contribute to board diversity as well as race, gender, and national origin.

Board Leadership Structure

Noting that a board's leadership structure is an important aspect of a company's corporate governance, the SEC has adopted disclosure requirements intended to increase transparency as to how a board functions. Each company must now briefly describe the leadership structure of its board, disclose whether and why it combines or separates the principal executive officer and board chairman positions, and explain why the company has determined that its board leadership structure is the most appropriate for the company. If the principal executive officer and board chairman positions are combined, the company must also disclose if it has a lead independent director and why,

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2 New Item 402(s) of Regulation S-K identifies the following situations which may trigger disclosure: a business unit carries a significant portion of the company's risk profile; compensation for one business unit is structured significantly differently than for other company units; a business unit is significantly more profitable than other units; a business unit's compensation expense is a significant percentage of the unit's revenues; and policies and practices which differ significantly from the company's overall risk and reward structure (such as bonuses which are awarded upon accomplishment of a task, while the income and the risk from such task extend over a significantly longer time period). In providing these examples, the SEC notes that a in these situations company under appropriate circumstances may conclude that it policies and practices may not be reasonably likely to have a material adverse effect on the company.

3 The rules also expand the list of legal proceedings which require disclosure to now include mail or wire fraud or fraud in connection with any business; proceedings based on securities or banking laws and regulations or any related settlement; and any disciplinary actions or orders imposed by stock exchanges or other self-regulatory organizations.

as well as the specific role that the lead independent director plays in the leadership of the board.

Accelerated Disclosure of Voting Results

The SEC has accelerated reporting of shareholder voting results to within four business days on a Form 8-K, from the current requirement to disclose voting results in the applicable Form 10-Q or Form 10-K.

Compensation

Disclosure Regarding Compensation Consultants

The SEC has expanded the disclosure requirements regarding compensation consultants to enable investors to better assess any incentives or potential conflicts of interest that a compensation consultant may have in recommending executive compensation. A company must now disclose compensation consultant fees as follows:

- If the board or compensation committee engaged a compensation consultant to provide advice or recommendations on either the amount or form of executive and director compensation, and the consultant or its affiliates provided additional services to the company during the fiscal year for fees in excess of $120,000, then the company must disclose the aggregate fees for the executive or director compensation services and the aggregate fees for the additional services.[4]

- If the board or compensation committee did not engage its own compensation consultant, but management engaged a compensation consultant to provide advice or recommendations on either the amount or form of executive and director compensation, and the consultant or its affiliates provided additional services to the company during the fiscal year for fees in excess of $120,000, then the company must disclose the aggregate fees for the executive or director compensation services and the aggregate fees for the additional services.

Notwithstanding the foregoing, services limited to consulting on any broad-based plans that do not discriminate in favor of executive officers or directors and are generally available to all salaries employees, or to providing information that is not customized for the company, or which is customized based on parameters not developed by the consultant, need not be considered as "executive compensation consulting services" for the purpose of these disclosure rules.

Reporting Stock and Option Awards

The new disclosure rules eliminate the annual expense reporting currently applicable to stock and option awards. Since 2007, the SEC has required companies to report the accounting expense incurred under FAS 123R (recently codified as Accounting Standards Codification Topic 718 "ASC 718") for such awards. The new rules require companies to report in the Summary Compensation Table and the Directors Compensation Table the aggregate grant date fair value of such awards granted during the year.

The rules also require companies to recalculate compensation in the Summary Compensation Table based on the grant date fair value of awards issued in prior years, but do not require the company to add or remove named executive officers if the result of such recalculation would affect the individuals previously included in such disclosure.

The new rules also revise the reporting requirements applicable to performance based stock and option awards. Currently, the SEC requires such awards to be valued assuming that the maximum performance achievement is attained. Under the new rules, the grant date fair value to be included in the Summary Compensation Table, Directors Compensation Table and Grants of Plan-Based Awards Table is to be determined based on the "probable outcome," determined as of the grant date, of the applicable performance conditions.

What Companies Should Do Now

- The board should review the principal risks facing the company (including those identified as risk factors in the company's SEC filings) and engage in ongoing discussions regarding such risks and risk management.

- The board should discuss with the company's CEO and CFO the company's processes for risk identification, risk management and risk reporting to the board.

[4] In addition, a company must disclose whether the decision to hire the consultant or its affiliates for such others services was made or recommended by management, and whether such services were approved by the board or the compensation committee.

- The board should specifically determine whether the board, a standing committee of the board or a newly established committee should be charged with the responsibility of overseeing specific types of risk.

- The board committees should consider the risks within their purview and report such risks and related risk management oversight to the board.

- The compensation committee should review the company's compensation policies and practices and whether they create risks that are reasonably likely to have a material adverse effect on the company. This review should include consideration of whether incentives created by the company's compensation programs would reasonably be expected to lead employees to take imprudent risks, and consideration of the time frames applicable to the earning and payment of incentives (e.g., should there be delay between the time of bonuses are earned and the time at which they are paid to enable the full consequences of decisions to be understood?).

- The corporate governance and nominating committee (or full board) should (i) discuss and determine the skills, experience, and background that it would wish to have represented on the board; and (ii) review the skills, experience, and background of current directors and nominees against the goals set by the corporate governance and nominating committee (or full board).

- Companies should update their annual director and officer questionnaires to address the new director and board nominee disclosure.

- The board or corporate governance and nominating committee should consider if and how they consider diversity issues when selecting director nominees.

- The board or its corporate governance committee should evaluate the company's leadership structure to determine what structure promotes board oversight and is best-suited for the company. This should include a review of whether and why the board chair and the CEO positions are combined or separated. The board or its corporate governance committee should define the duties of the non-executive chair or the lead outside director, as appropriate.

- The compensation committee should review and consider the role and independence of the company's compensation consultants.

- To the extent a company can identify its "named executive officers" for 2009, the company can begin to recompute the equity award disclosure for the two prior completed fiscal years. The stock and option award columns must be revised to present the applicable full grant date fair value and the total compensation column must be updated as well.

- Companies should watch for any additional guidance from the SEC concerning the new rules.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit our Corporate Finance page or Employee Benefits page.

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