

## **HAVE YOU BEEN NAUGHTY OR NICE? CONFESSING TO RISKY COMPENSATION STRUCTURES (AND OTHER NEW SEC DISCLOSURE RULES)**

December 23, 2009

To Our Clients and Friends:

On December 16, 2009, the Securities and Exchange Commission (SEC) adopted final rules amending the disclosures that registrants must make about compensation and other corporate governance matters. The rules were adopted largely along the lines proposed, though with some changes that are significant. The rules are intended to enhance the information provided to shareholders to enable them to make more informed voting and investment decisions and require:

- a discussion of compensation policies and practices for the company's employees (not just the executive officers) that create risks that are "reasonably likely to have a material adverse effect" on the company;
- use of the full grant date value of equity awards (as opposed to the value recognized by the company in its financial statements) in the Summary Compensation Table and the Directors Compensation Table;
- additional disclosure about the background and qualifications of directors and nominees, diversity policies related to board membership, the board leadership structure and the board's role in risk oversight; and
- disclosure about potential compensation consultant conflicts of interests.

In addition, the final rules accelerate the timing of reporting the results of a shareholder vote by requiring the disclosure on a Form 8-K within four business days of the shareholder meeting. The SEC deferred consideration of changes to the proxy solicitation rules until it considers the proxy access proposal.

### **EFFECTIVE FOR 2010 PROXY SEASON**

The final rules will be effective on February 28, 2010, meaning that they will apply to most calendar year registrants during the 2010 proxy season.

### **COMPENSATION DISCLOSURE REQUIREMENTS**

**Compensation Policies and Risk Management.** The final rules require companies (other than small business issuers) to discuss their compensation policies and practices for employees generally,

including non-executive officers, as they relate to risk and incentives that can affect the company's risk and risk management, if these compensation policies and practices "create risks that are *reasonably likely* to have a *material adverse effect* on the company" (*emphasis added*). The "reasonably likely" standard is the same as is used in the Management's Discussion and Analysis. This is a significant change from the proposed rules, which would have required disclosure if such risks "may" have a "material effect" on the company. In determining whether risks are reasonably likely to have a material adverse effect, companies may consider policies and practices that mitigate or balance incentives to offset the risks involved. This discussion will not be included in the Compensation Discussion and Analysis (CD&A); it will be part of a separate paragraph in the proxy statement. However, as noted by the SEC (repeating a point made in the proposing release), if risk considerations are a material aspect of the compensation decisions for named executive officers, the company is required to discuss them in the CD&A.

The final rules contain the same non-exclusive list of situations where compensation programs have the potential to create risks that are reasonably likely to have a material adverse effect and the same illustrative examples of the issues that companies may need to address as the proposed regulations.<sup>1</sup> Importantly, the final rules do not require a company 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. That said, companies will still need to analyze the risks of their compensation practices to make the determination as to whether or not any disclosure is required.

**Equity Compensation.** The final rules change how stock and option awards are to be disclosed in the Summary Compensation Table and the Directors Compensation Table. Companies must now report the full grant date fair value of options and other equity awards for the year in which they are awarded to executives, rather than the amount recognized for financial statement purposes for the fiscal year. For *performance awards*, the value reported should be computed based upon the probable outcome of the performance condition (or conditions) as of the grant date, consistent with the estimate used for accounting purposes. The new rules also require footnote disclosure of the maximum value of the awards assuming the highest level of performance conditions is achieved.

This amended disclosure may affect the determination of which executive officers, other than the chief executive officer and the chief financial officer, are the highest paid officers and therefore required to be included in the Summary Compensation Table as named executive officers. Where company compensation decisions, including decisions to grant "new hire" or "retention" awards, cause the named executive officers to change, the rules permit companies to include supplemental compensation disclosure for executive officers who otherwise would have been subject to reporting

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<sup>1</sup> For a discussion of these risk-creating situations and discussion topics, see our July 15, 2009 Client Update discussing the proposed regulations at <http://www.debevoise.com/newsevents/pubs/publications/detail.aspx?id=95320aff-2fbb-4e4e-9fcb-1ed100a29a7e>.

(allowing disclosure for more than five officers, but not relieving a company of the obligation to disclose the new hire or retention award recipients in the table).

There is no transition relief for this revised rule. For companies with fiscal years ending on or after December 20, 2009, amounts that are to be reported for 2008 and 2007 in next year's proxy statement must be recomputed in accordance with the new rules as well.

## **BOARD DISCLOSURE REQUIREMENTS**

**Directors and Nominees.** Under the final rules, companies must disclose each director's and director nominee's "particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director for the company . . . ." The same disclosure for any nominee for director put forward by another proponent is required in the proxy soliciting materials of that proponent. The new disclosure is required annually for all nominees and for all directors, including those not up for reelection. The SEC has not specified the particular information that must be disclosed, providing flexibility to include information most relevant to the company. The SEC noted, however, that if particular skills, such as risk assessment or financial reporting expertise, were part of the specific qualities that led the board to conclude that the person should serve as a director, this should be disclosed. The existing requirements regarding the specific minimum qualifications and specific qualities or skills used by the nominating committee are being retained to allow investors to compare and evaluate the skills and qualifications of each director and nominee against the standards established by the board. Thankfully, the SEC did not adopt the proposed rule requiring disclosure of the specific experience, qualifications or skills that qualify a person to serve as a board committee member.

The final rules require disclosure of any directorships at public companies and registered investment companies held by each director and nominee during the past five years instead of only current directorships. The final rules also lengthen the time during which disclosure of legal proceedings involving directors, director nominees and executive officers is required from five to ten years and expand the list of legal proceedings required to be disclosed.

**Disclosure About Diversity in the Director Nomination Process.** In a surprise addition, the final rules require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director. If the committee or the board has a policy that considers diversity in identifying director nominees, the company must disclose how this policy is implemented and how the committee or the board assesses the effectiveness of the policy. The SEC does not define diversity, allowing companies to define diversity in ways that they consider appropriate, including 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.

**Board Leadership and Risk Oversight Disclosure.** Under the final rules, a company must include a discussion of the board leadership structure, including whether and why the company has combined or separated the chief executive officer and chairman positions, and why the company believes its board leadership structure is the most appropriate for the company at the time of the filing. If the roles of CEO and board chairman are combined, disclosure is required as to whether and why a company has a lead independent director and the specific role of such director. The SEC explained that these amendments are intended to provide more transparency about a company's governance structure, but are not intended to influence a company's decision regarding board leadership structure.

The company must also discuss the extent of the board's role in the oversight of risk and the risk management process. This disclosure allows a company 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. A company, where relevant, should disclose whether the individuals who supervise day-to-day risk management responsibilities report directly to the board or to a committee, or how the board or committee otherwise receives information from such individuals.

#### **COMPENSATION CONSULTANTS FEES**

The final rules require fee (and other) disclosure related to the retention of a compensation consultant where the compensation consultant or its affiliates also provide other consulting services, such as benefits administration, human resources consulting, or actuarial services, if the fees for the other consulting services exceed \$120,000 annually. If the board has its own consultant, however, fee disclosure for consultants that work with management is not required. 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, are not considered consulting services for purposes of these rules. Unlike the proposed rules, the final rules do not require disclosure of the nature or extent of additional services provided to the company by the compensation consultant or its affiliates.

#### **REPORTING OF VOTING RESULTS ON FORM 8-K**

The final rules add a new Item to Form 8-K requiring companies to disclose the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. The requirements to disclose shareholder voting results on Forms 10-Q and 10-K have been eliminated. If it may take longer to determine definitive voting results, companies must file the preliminary voting results within four business days after the end of the shareholders' meeting, and then file an amended Form 8-K within four business days after the final voting results are known.

**PREPARING FOR DISCLOSURE**

In light of the new rules and the short timeframe for compliance in the 2010 proxy season, a company should consider taking the following actions:

- review the company's board leadership structure and consider why the structure is appropriate for the company;
- update director and officer questionnaires and board policies and procedures in the context of the new rules;
- review risks related to compensation policies and practices to determine whether they are reasonably likely to have a material adverse effect on the company;
- begin the process of recalculating the value of equity grants for the proxy statement compensation tables based on the new rules;
- review the company's existing diversity policy for directors or determine whether such a policy should be adopted;
- consider the board's oversight of the risk management process and if and how such oversight could be strengthened; and
- identify and review compensation consultant services and fee structures.

Please contact any of us if you would like to discuss the new rules further or how they may affect your company's filings.

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