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securities and executive compensation lawflash

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SEC Issues Final Guidance on Executive Compensation Disclosure

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On December 16, the Securities and Exchange Commissioners adopted final amendments to the proxy disclosure rules to enhance compensation and other corporate governance disclosures.[1] The final amendments are applicable to definitive proxy statements mailed on or after February 28, 2010, which means that most companies will have to comply with the amendments in the upcoming proxy season. The amendment to the equity award disclosure rules applies to only those companies with fiscal years ending after December 20, 2009. Below, we briefly summarize the new requirements and, where needed, how they differ from the July 10 proposed amendments.[2]

- **Risk assessment of compensation policies and practices.** If a company's compensation policies and practices for employees create risks that are "reasonably likely to have a material adverse effect on the company," the company must discuss in the proxy statement its compensation policies or practices as they relate to risk management. (The July 10 proposal used the standard "may have a material effect on the company.") This requirement applies to a company's compensation policies and practices for employees generally and not just those applicable to executive officers.

  According to the release, if a company concludes that its compensation policies and practices do not create risks requiring disclosure, the company need not affirmatively disclose its determination. Nevertheless, some companies may decide to voluntarily disclose that they conducted a risk analysis even if they conclude that no disclosure is required. The Staff also noted that companies, when assessing whether disclosure is required, can take into account factors that limit risks of certain compensation arrangements (e.g., clawbacks). This new disclosure requirement is not applicable to smaller reporting companies.

  If a company must include the discussion, it will appear in a separate section that is not a part of the Compensation Discussion and Analysis, or "CD&A." The release contains the following examples of issues that a company may want to address if it determines that disclosure is required:

1 The final release has not yet been published in the Federal Register, but the SEC posted the release on its website at http://www.sec.gov/rules/final/2009/33-9089.pdf.

2 For further information regarding the July 10 proposed amendments, see Morgan Lewis's July 21, 2009 LawFlash, online at http://www.morganlewis.com/pubs/Securities+EC_ExecCompCorpGovDisclosure_LF_21jul09.pdf.

    - 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 they 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 clawbacks or imposing holding periods

    - The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile

    - Material adjustments to the company's 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 determine whether its risk management objectives are being met

- **Grant date fair value rather than the annual accrued expenses for equity-based awards.** In the Summary Compensation Table and the Directors Compensation Table, companies must disclose the aggregate grant date fair value of stock and equity-based awards granted during the fiscal year (even if the grant relates to another fiscal year), rather than the annual accounting charge as under current rules. Companies must use this approach for all years reported in the tables, which means that they must recalculate the amounts shown for 2007 and 2008 in the Summary Compensation Table equity award and total compensation columns, but only with respect to the named executive officers previously included in prior filings. Companies need not re-determine named executive officers for any preceding fiscal year based on total compensation for those years recomputed pursuant to the new rules.

  The values in the Summary Compensation Table, the Grants of Plan-Based Awards Table, and the Directors Compensation Table for performance-based equity awards should take into account the probability of achieving the targets; if different, the maximum award value should be disclosed in a footnote to the tables. The final rule did not change the existing requirements to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table and in the corresponding footnote disclosure to the Directors Compensation Table.

  If a company reprices options or stock appreciation rights during the reporting period, the company must include in the Summary Compensation Table the incremental fair value of the new award over the old award as of the modification date.

- **Qualifications and backgrounds of directors and nominees and information about legal proceedings involving directors, nominees, and executive officers.** The Securities and Exchange Commission (SEC) adopted, generally as proposed, the expanded disclosure requirements relating to the specific experience, qualifications, attributes, and skills of directors and nominees, public-company directorships held during the prior five years, and involvement in certain legal proceedings going back 10 years. The final rule did not adopt the proposal to require disclosure of specific experience, qualifications, or skills that qualify a person to serve as a committee member.

In addition, the rule expands the list of legal proceedings requiring disclosure. Companies must disclose any federal or state judicial or administrative order, judgment, decree, or finding, not subsequently reversed, suspended, or vacated, relating to any legal proceedings, which is now defined to include (a) any judicial or administrative proceedings (i) resulting from involvement in mail or wire fraud or fraud in connection with any business entity or (ii) based on violations of federal or state securities, commodities, banking, or insurance laws and regulations, or any settlement to such actions; and (b) any disciplinary sanctions or orders imposed by a stock, commodities, or derivatives exchange or other self-regulatory organization.

Companies need not disclose settlements relating to civil proceedings among private parties.

In the proposing release, the SEC had requested comments relating to board diversity. The final rule requires companies to disclose whether—and if so, how—its nominating committee considers diversity when selecting director nominees. If the nominating committee or the board has a diversity policy, the company must disclose how the policy is implemented and how the nominating committee or board assesses the effectiveness of the policy. The release does not define "diversity" because, according to the Staff, companies should be allowed to define diversity in ways that they consider appropriate.

- **Board leadership structure.** The SEC adopted, generally as proposed, new disclosure requirements relating to a company's leadership structure, including whether the company has chosen to combine or separate the chief executive officer and board chair positions, why the leadership structure is appropriate for the company, and, if one person serves as both the chief executive officer and chairman of the board, whether the company has a lead independent director and the role of the lead independent director. The SEC, in the final release, explained that this new disclosure is not intended to influence a company's leadership structure, but rather is intended to provide insights to shareholders regarding the choice of a particular leadership structure.

  Companies must also discuss, in the corporate governance disclosures, the extent of the board's role in "risk oversight" (as opposed to "risk management," which is the term that was used in the proposed amendments). Companies should generally address how the board administers its risk oversight function, such as through the whole board or through a separate risk or audit committee. The release provides that the board's approach to risk oversight might address questions such as whether the persons who oversee risk management report directly to the board or to a board committee, or how the board or board committee receives information from such individuals.

- **Fees paid to and services provided by compensation consultants.** The proposed amendments would have required additional disclosure by companies that engage a compensation consultant and use the same consultant or an affiliate of the consultant to provide additional services to the company (for example, benefits administration, human resources consulting, and actuarial services). The final rule provides exceptions from the disclosure requirements for situations that do not raise potential conflicts of interest. Accordingly, additional disclosure will be required only if the company pays more than $120,000 for nonexecutive-compensation-related services to the same consultant or affiliate that provides executive-compensation-related services to the company, the board, or compensation committee. Disclosure under the final rule is required as follows:

If the board or compensation committee has engaged its own consultant to provide executive-compensation-related services and the consultant or its affiliates provides nonexecutive-compensation-related services to the company in excess of $120,000 during the fiscal year, then the company must disclose:

- The aggregate fees paid with respect to executive-compensation-related services and the aggregate fees paid for other services (but the company need not disclose the nature and extent of those additional services)
- Whether management recommended or decided to engage the consultant for nonexecutive-compensation-related services
- Whether the board or compensation committee approved the other services, if applicable

If the board or compensation committee has not engaged its own consultant, but management has engaged a consultant to provide executive–compensation-related services and nonexecutive-compensation-related services and the consultant or its affiliates provides nonexecutive-compensation-related services to the company in excess of $120,000, the company must disclose the aggregate fees paid with respect to executive-compensation-related services and the aggregate fees paid for other services.

Disclosure is not required with respect to consulting services provided to management (regardless of amount) if the board engages its own (different) consultant.

The original proposal would also have required a description of the additional services, but that requirement was not adopted. The final release provides that companies may voluntarily include a description of any nonexecutive-compensation-related services provided by the compensation consultant if such information would facilitate investor understanding of the existence or nature of any potential conflict of interest.

There are also exclusions for services relating to broad-based plans and for generic survey information. The exception for surveys will not be available if a survey is customized for a company or the compensation consultant provides advice in connection with presenting the survey.

- **Accelerated disclosure of annual meeting voting results.** The SEC adopted, generally as proposed, the proposal to accelerate the disclosure of voting results after the end of the meeting at which the vote was held rather than the current obligation to disclose such results on Form 10-Q or Form 10-K. Companies must now disclose voting results on a Form 8-K within four business days after the meeting at which the vote was held, even if the voting results are not final. If a company discloses preliminary voting results, the company must file an amended Form 8-K disclosing the final voting results within four days after certifying the results.

Current Action Items for Clients

Although the rules do not take effect until February 2010, they will have an immediate impact on a company's current corporate governance practices. Companies should consider:

- Conducting a risk assessment of its compensation policies and practices for employees that create risks that are reasonably likely to have a material adverse effect on the company, and assessing what policies are in place to monitor and mitigate these risks.

- Revising director and executive officer questionnaires in order to request the following:

    - Information for the last 10 years instead of the last five years where applicable

    - Additional information regarding past legal proceedings

    - For directors, past directorships

    - Such other information as will be considered by the nominating committee or board in articulating the qualifications of directors and director nominees

- Developing a process and schedule for the nominating committee of the board to address the following:

    - A nominee's experience, qualifications, attributes, or skills so these can be formally evaluated, and so the appropriate disclosures can be developed

    - The board leadership structure and any board policies for the consideration of diversity in board composition

- Gathering information on all engagements by the company and its worldwide subsidiaries, if applicable, of its board and management compensation consultants. It may be prudent for compensation committees to establish procedures, similar to the procedures used by audit committees for approval of nonaudit services, for "preapproving" any additional services provided by their compensation consultants.

- Using the aggregate grant date fair value of equity grants in 2009 to identify the company's named executive officers for 2009.

This is only the most recent proxy guidance. The proposed proxy access rules and proposals regarding "say on pay" have been deferred until 2010. As a result, we can expect additional proxy rule proposals to come in the near term.

Lastly, companies should not expect a liberal transition period for these new rules. Unlike SEC comments to proxy statements in the last two years in which the Staff allowed companies to correct disclosure in future proxy filings, the SEC has recently indicated, in a November 2009 speech by the deputy director, that the Staff will require companies to prepare amended filings if they determine that a company's disclosures or lack of disclosures do not materially comply with these new proxy rules, which are generally effective immediately.

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