

July 17, 2009 | Posted By

Changes in Store for 2010 Proxy Season as SEC Proposes Significant Expansion of Executive Compensation and Corporate Governance Rules and Treasury Releases Draft New Legislation

As anticipated and in response to the “turmoil in the markets during the past 18 months”, on July 10, 2009 the Securities and Exchange Commission (“SEC”) [proposed](#) substantial amendments to the executive compensation and corporate governance disclosure requirements for publicly held companies.

As we last reported in our [June 18, 2009 Blog Article](#), the SEC’s proposed rules continue the federal government’s coordinated efforts to (i) reform executive compensation practices, (ii) push corporate boards to have greater accountability, and (iii) provide shareholders with greater visibility into the how and why of compensation decision-making and the relationship between compensation policies and company risk. The SEC’s latest proposal continues their recent spate of releases geared towards increasing investor awareness of companies’ executive compensation practices and providing shareholders with a greater voice in their companies. This includes the [SEC’s June 10, 2009 release](#) to better enable shareholders to exercise their rights to nominate and elect directors and the [SEC’s July 1, 2009 release](#) proposing rules governing shareholder approval of executive compensation (“Say-on-Pay”) for companies that have received assistance under the federal government’s Troubled Asset Relief Program (“TARP”).

The SEC’s July 10, 2009 proposals include the following:

- **Compensation Policies.** If the risks arising from a company’s compensation policies or practices could have a material effect on the company’s overall risk exposure, the company’s Compensation Discussion & Analysis (“CD&A”) would need to include a section discussing: overall compensation policies (covering employees besides the named executive officers), compensation incentives that affect risk-taking, adjustment of compensation in light of risk issues, and the company’s assessment of such risks.
- **Equity Compensation Value.** In a change that likely will be welcomed by companies and investors alike, the grant date value for the numerical disclosure of the estimated values of equity-based compensation awards determined under FAS 123(R) will be used as compared to the current requirement of using the annual financial accounting expense recognized for such awards in the Summary Compensation Table and Directors Compensation Table.

- **Director Qualifications.** Expansion of the discussion of a director/nominee's experience and qualifications that will more specifically describe the individual's skills and the basis for being qualified to serve on the company's board of directors.
- **Leadership Structure and Risk Management.** Disclosure of a company's leadership structure and why such structure is the best arrangement for the company. This would include articulating why there was a separation (or integration) of the principal executive officer position and the chairman of the board position along with a discussion about the lead independent director (if any). The board's role in risk management would also need to be addressed.
- **Potential Compensation Consultant Conflicts of Interest.** Provided that a company's compensation consultant(s) provided other services to the company, there would need to be disclosure of aggregate fees paid to any such compensation consultants along with a description of such other services. Additionally, the involvement of management in selecting the consultant for non-compensation services and whether the board (or compensation committee) approved the non-compensation services of the consultant would also need to be disclosed.
- **Shareholder Vote Results.** Accelerated disclosure on Form 8-K of results on proposals voted on by shareholders would be required within four business days of a shareholder meeting rather than the existing practice of providing such disclosures on the next filed Form 10-Q or 10-K.
- **Proxy Solicitation and Other Potential Reforms to Executive Compensation.** Proposed reforms to proxy solicitation and SEC requests for comments on a variety of other executive compensation reform topics were also contained in the release.

Comments on the proposed amendments may be provided to the SEC on or before 60 days from the date of the proposed amendments' publication in the Federal Register. The SEC is working to adopt final rules in time for the 2010 proxy season.

Given the continuing high level of public and regulatory scrutiny of executive compensation, the SEC proposals will likely draw many comments. And while changes will presumably be made to the rules as currently proposed, some form of the proposals will probably be adopted. In a related development, on July 16, 2009, the Treasury Department released draft legislation, the "[Investor Protection Act of 2009](#)," on Say-on-Pay and heightened independence standards for compensation committees. The Treasury further released fact sheets on both aspects of the legislation as well ([Say-on-Pay fact sheet](#) and [compensation committee independence fact sheet](#)). The draft legislation and new fact sheets follow up on the Treasury's statements in June 2009 on [compensation principles](#), [Say-on-Pay](#) and [compensation committee member independence](#) (see our [June 18, 2009 Blog Article](#)). All of the proposed legislation is consistent with the [President's White Paper](#) on financial regulatory reform which was released in June 2009. Additionally, on

July 16, 2009 Congressman Barney Frank issued a [statement](#) that the House Committee on Financial Services would begin marking up the legislation as early as next week in response to recent press coverage of the high levels of compensation still being awarded at some of the country's financial institutions. Given the breadth and depth of the SEC's proposed changes and their open-ended request for comments on other executive compensation reform items, along with the Treasury Department's own endeavors to reform executive compensation practices, public companies would be well advised to examine their existing compensation/risk management processes and practices, D&O questionnaires, committee charters, organizational structure and public disclosures. Interested parties may also wish to submit comments to the SEC and perhaps affect the shape the final rules will take.

For further details on the proposed rules along with representative comments the SEC is soliciting from the public on its proposals, please read the following discussion.

Compensation Policies

In an attempt to create greater accountability at the corporate level, the proposed SEC amendments would require companies to provide investors with more details on the company's overall compensation structure and its relationship to the company's exposure to various risks. Federal government regulators have made it abundantly clear that they believe that incentive compensation programs at certain financial institutions encouraged excessive risk taking by their executive officers in order to enhance short-term company results (and correspondingly greater compensation payments to top executives) at the expense of long-term growth and prosperity. The view is that such compensation policies played a major role in causing the financial crisis, resulting in the collapse of many companies, and the federal government's dramatic intervention into the private sector in the form of the TARP and stimulus bill. The heightened disclosure of compensation policies required by the proposed amendments is also in response to the view that the compensation of other employees may have become "disconnected" from long-term performance. The desired purpose is to foster better alignment between the incentive compensation of employees and the long-term well-being of the company and to avoid having compensation policies that promote excessive risk-taking by employees.

Effective with the 2007 proxy season, the SEC has required a "principles-based narrative discussion" of a company's compensation program for its named executive officers in the CD&A section. The proposed amendments would expand the scope of the CD&A to include a section discussing how the company's broader compensation policies for its employees (not just the named executive officers) could create incentives that would affect the company's overall exposure to risks and the company's assessment of those risks. The release provides illustrative examples of situations and issues that could merit discussion in this section of the CD&A. If, however, the company determines that the risks arising from its broader compensation policies are not material, then disclosure would not be required.

Representative Comments that the SEC is Requesting:

- Should the scope of the amendments be limited to certain employees at a company or companies of a certain size in a certain industry?
- Should the rules reflect that the cost of tracking and disclosing the nature of the risks may vary across companies or within a company?
- Should a company be required to affirmatively state in its CD&A if it has determined that its broader compensation policies are not reasonably expected to have a material effect on the company?
- Should smaller reporting companies, who do not currently have to provide a CD&A, be subject to these enhanced disclosures on compensation and risk?

Equity Compensation Value

The amendments also propose to change the manner in which stock and option awards are reported on the Summary Compensation Table and Director Compensation Table. The change would require companies to report these awards using their aggregate grant date fair value estimated in accordance with FAS 123(R) instead of reporting the expense amount recognized for financial statement reporting purposes for the fiscal year. This change is in response to comments that the estimated grant date value is more useful to investors than the annual expense amount and also in order to simplify the disclosures. Adoption of this amendment would effectively reverse the SEC's surprise decision in December 2006 to utilize annual expense figures rather than grant date values.

Representative Comments that the SEC is Requesting:

- Should the prior year equity award figures in the Summary Compensation Table be restated to reflect the new valuation method and is there a better approach to preserve year-to-year comparability of equity award compensation amounts?
- Is another method of reporting equity compensation values preferred?

Director Qualifications

The proposed amendments also expand the disclosure requirements for directors and nominees and are

intended to provide investors with more information about a director's credentials and possible conflicts of interest. These changes expand both the type of information required to be disclosed as well as the time frame from which the information must be disclosed. A company would need to provide disclosure regarding the specific experience, expertise and skills that qualify the person to serve on the board and committees of the board and articulate why such individual's service on the board will be beneficial to the company. Biographical information would be expanded to include any public company directorships held during the past five years by each director or nominee as compared to the current requirement of reporting only current directorships. The time period from which to disclose legal proceedings involving the director/nominee would be expanded from the last five years to the last ten years. The stated objective of these proposed changes is to help investors determine whether an individual director and the entire board composition as a whole are appropriate choices. In short, the SEC wants companies on an on-going basis to provide a greater justification to investors for why certain individuals are desirable board members.

Representative Comments that the SEC is Requesting:

- Should the rules be amended to compel a discussion of board diversity?
- Should the frequency of the expanded director qualification disclosures occur less often than annually?
- Should the expanded director qualification requirements cover directors on all committees or instead be focused on certain key committees such as the audit, nomination/governance, and compensation committees?
- Should there be any special accommodations for smaller reporting companies?

Leadership Structure and Risk Management

Under the proposed amendments, companies would now be required to disclose their leadership structure and why they think it is the best structure for the company. Companies would also be required to disclose in proxy and information statements the board's role in the risk management process. More specifically, companies would have to disclose whether and why they have chosen to combine or separate the principal executive officer and board chairman positions. In companies where the role of principal executive officer and board chairman are combined and a lead independent director is designated to chair meetings of the independent directors, the company would need to disclose why this structure was chosen and what specific role the lead independent director plays in the company. Even if a company does not utilize one of these particular structures, it would still need to disclose and explain the structure that is in place.

Companies would also need to disclose the role the board plays in risk management. As an example, companies would need to disclose whether the board implements its risk management function through the board itself or through a committee, such as the audit committee, and the reporting relationships for the company's risk managers. These new disclosures are an effort to address the problems surrounding risk management that are frequently cited as a major factor in creating the on-going economic crisis.

Representative Comments that the SEC is Requesting:

- Should the amendments include more specific disclosures such as how the company determines the number of independent directors on the board?
- Should the SEC make special accommodations for smaller reporting companies?
- Should the SEC require additional disclosures regarding risk management in other registrant filings?

Potential Compensation Consultant Conflicts of Interest

If compensation consultant who helps determine or recommends the amount or form of executive or director compensation also provides other services to the company, the proposed amendments would require disclosure of fees paid to such compensation consultant. The required disclosures would include the nature and extent of the other services provided, the aggregate fees paid for the compensation-related services and the other services, whether the decision to hire the consultant for the other services was reviewed or screened by management, and whether the board or the compensation committee approved the consultant becoming a provider of the other services. The principal purpose of these added disclosures would be to provide investors with information about possible conflicts of interest for the consultant. The concern expressed by some investors is that executive compensation recommendations by the compensation consultant could possibly be affected by the consultant's relationship with management by virtue of providing other services to the company.

Representative Comments that the SEC is Requesting:

- Would the disclosure of additional consulting services and related fees adversely affect the ability of a company to hire consultants?

- Should there be additional disclosures relating to other potential conflicts of interest of compensation consultants?
- Should a minimum threshold amount or percentage of income be established for requiring disclosure of fees?

Shareholder Vote Results

In order to promote more timely disclosure of voting results from shareholder meetings, the proposed amendments would change the time period in which companies are required to disclose voting results. Shareholder voting results would now be reported on a publicly filed Form 8-K within four business days of the shareholder meeting. Previously, the disclosure of shareholder vote results could be reported on a Form 10-Q or 10-K which could result in a gap of several months between the shareholder meeting and the disclosure of voting results. The amendments would provide some relief in the event of a contested election whose results were not certified as final within four business days of the shareholder meeting.

Representative Comments that the SEC is Requesting:

- Could the disclosure of preliminary voting results in a contested election have negative consequences?
- Are there alternative methods, besides Form 8-K, that would more effectively provide voting results to investors?

Proxy Solicitation

The proposed amendments also seek to clarify the manner in which soliciting parties communicate with shareholders. Specifically, the amendments propose to change the proxy solicitation rules so that:

- a "form of revocation" does not include an unmarked copy of management's proxy card that a soliciting shareholder requests be returned directly to management, so that parties seeking to campaign for a certain vote, but who do not wish to solicit a proxy, do not have to meet the full requirements for proxy solicitation;
- disclosure of a substantial conflict of interest by a soliciting party is not limited to parties who are shareholders of the class of securities being solicited and the benefit to that party need not be solely related to or derived from the holding of a security;

- a person soliciting in support of nominees who, if elected, would constitute a minority of the board may seek authority to vote for another soliciting person's nominees in addition to or instead of the issuer's nominees to round out its short slate; and
- the requirement that the proxy statement or form of proxy provide that the shares represented by the proxy be voted "subject to reasonable and specified conditions" will require that "reasonable and specified conditions" be objectively determinable.

Other Potential Reforms to Executive Compensation

The SEC is exploring ways to improve proxy disclosures and in this regard it requested comments on a number of other executive compensation reform topics including the following:

- Should the SEC consider other initiatives to improve disclosures, especially about executive compensation, such as the compensation of every executive, not just the named executive officers?
- Should the SEC amend the rules so that the Compensation Committee report is "filed" rather than "furnished" and therefore subject to greater liability?
- Should any of the narrative or tabular disclosure requirements require additional disclosures about whether or not a company has "hold to retirement" and/or "clawback" provisions?
- Should companies be required to disclose internal pay ratios in order to inform investors of internal pay equity considerations in compensation decisions?
- Should tax gross-up arrangements for any named executive officer also include a disclosure on the savings that accrue to the covered officer?

If you have any questions regarding this information, please contact [Greg Schick](#) at (415) 774-2988.