SUTHERLAND

LEGAL ALERT

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SEC Tackles Proxy Disclosure Rules

On December 16, 2009, the SEC adopted enhancements to the current proxy disclosure requirements (the "Proxy Disclosure Rules" or the "new rules") in a 4-1 vote.[1] The new rules are the first to be formally adopted under SEC Chairman Mary Schapiro and follow a succession of proposed rule changes issued by the SEC in response to the financial crisis.[2] The Proxy Disclosure Rules, as approved, largely track the rules proposed by the SEC in July.[3] The new rules will require a company to disclose or enhance its disclosure of:

- compensation policies as they relate to risk;
- potential conflicts of interest with regard to compensation consultants;
- stock and option compensation awards;
- director and nominee qualifications and background;
- diversity policies relating to board membership;
- the rationale behind company leadership structure; and
- shareholder voting results on Form 8-K.

The new rules become effective **February 28, 2010,** and therefore are applicable to the coming proxy season. The SEC has clarified that an issuer whose fiscal year ends on or after December 20, 2009, must be in compliance with the new proxy disclosure requirements if its Form 10-K and proxy statement are filed on or after February 28, 2010.[4] If a company files its 2009 annual report on Form 10-K before February 28, 2010, and its proxy statement on or after February 28, 2010, the proxy statement must comply with the new rules.

A more detailed summary of the new Proxy Disclosure Rules, as approved, is provided below.

Disclosure of Compensation Policies and Risk Management

In the wake of the current market turmoil, the topic of risk management and risk assessment has attracted significant public scrutiny. The new rules are intended to address compensation policies that may encourage risk-taking, which many believe is an underlying factor of the financial crisis. To that end, the adopted rules require a company to provide an analysis of its broader compensation policies and overall

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[1] Proxy Disclosure Enhancements, Securities Act Release No. 9,089, Exchange Act Release No. 61,175, Investment Company Act Release No. 29,092 (adopted December 16, 2009), available at http://www.sec.gov/rules/final/2009/33-9089.pdf

[2] SEC Commissioner Kathleen Casey voted against the approval of the rules, expressing concern about mandated disclosure on a person-by-person basis on the board's selection of particular nominees as well as the new requirement that a board assess how it has implemented diversity policies.

[3] Proxy Disclosure and Solicitation Enhancements, Securities Act Release No. 9,052, Exchange Act Release No. 60,280, Investment Company Act Release No. 28,817 (proposed July 10, 2009), available at http://www.sec.gov/rules/proposed/2009/33-9052.pdf

[4] SEC Transition Guidance, *Proxy Disclosure Enhancement Transition*, Dec. 22, 2009, available at http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm.

actual compensation practices if risks arising from those compensation policies or practices are reasonably likely to have a material adverse effect on the company.[5]

Under the adopted rules, the new risk management disclosure requirement is not limited to executive compensation but rather considers the compensation of all employees. Disclosure requirements currently in place address only the level of risk that a company's named executive officers might be encouraged to take in order to receive incentive bonus compensation from the company.[6] It is worth noting that the new disclosure requirements will not be a part of a company's Compensation Discussion and Analysis (the "CD&A") as originally proposed.[7]

The adopting release to the rules provides a non-exhaustive list of examples of the types of discussion the SEC would expect if disclosure is required, including:

- the general design philosophy of the company's compensation policies for employees whose behavior would be most affected by the incentives established by the policies, as they relate to or affect risk-taking by those employees on behalf of the company;
- the company's risk assessment or incentive considerations in structuring 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 the long term;
- the company's policies regarding adjustments to compensation to address changes in its risk profile; and
- 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.

When proposed, this rule change was unsurprisingly controversial due to its inherently speculative standard. In response, the SEC did change the rule from the proposed standard, which required disclosure of compensation policies that "may" have a material effect on the registrant, to the adopted standard, which requires disclosure if a policy is "reasonably likely" to have a material adverse effect.[8] This approach borrows from the SEC's Management's Discussion and Analysis (the "MD&A") requirements and should parallel the rule mandating risk-oriented disclosure of known trends and uncertainties material to the business in the MD&A.

At the open meeting adopting the rules, the SEC noted that companies may consider mitigating factors before concluding that a compensation practice or policy is reasonably likely to have a material adverse effect on the company. The SEC highlighted in the adopting release that compensation policies and practices for different groups within a company that balance incentives may offset incentives in other

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[5] This language borrows from a similar requirement in place for TARP recipients. *See* William B. Asher, *Anticipating Exec Compensation, Disclosure Rules*, LAW360, Oct. 6, 2009.

[6] Even though the rule will not be part of the CD&A, smaller companies still will not be required to provide the new disclosure. Smaller reporting companies are similarly not required to provide CD&A disclosure.

[7] This analysis will be a separate paragraph of Item 402 of Regulation S-K. The SEC made this change in response to concerns that the expansion of the CD&A beyond named executive officers would confuse investors since the new disclosure requirements would cover all employees.

[8] Melissa K. Aguilar, *Comments Are in on SEC's Proxy Disclosure Proposal*, COMPLIANCE WEEK, Sept. 22, 2009; see comment made by Hye-Won Choi of TIAA-CREF, available at http://www.sec.gov/comments/s7-13-09/s71309-32.pdf (last accessed Oct. 8, 2009).

groups and may be considered when deciding whether risks arising from the company's compensation policies are reasonably likely to have a material adverse effect on the company as a whole.

Revisions to the Summary Compensation Table

The new rules revise the Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards.[9] Companies now must disclose the aggregate grant date fair value of the awards,[10] rather than the current dollar amount recognized for financial statement reporting purposes.

In order to implement the transition to the new rules, companies must re-calculate three years of the grant date fair value of stock and stock-based awards in the Summary Compensation Table to allow for easier year-to-year comparison. Pursuant to the new rules, companies will be required to re-compute the value of equity awards for any past fiscal years that are required to be included in the table for each executive officer included in this year's proxy statement. Companies should be aware that implementation of this aspect of the new rules may affect the composition of the group of named executive officers; however, the SEC has stated that it would not expect companies to amend prior filings to include different named executive officers.

The rules as approved also contain a special instruction relating to performance-based awards in order to address concerns that the rules might discourage use of these awards or result in inflated reporting. Under the amended rule, the Summary Compensation and Director Compensation tables will include the value of performance-based awards at the grant date based on the probable outcome of the performance conditions as of the grant date. The SEC will require footnote disclosure of the maximum value of these awards assuming the highest level of performance conditions is probable. The SEC stated that the footnote is intended to permit investors to understand an award's maximum value without raising the concerns created by its tabular disclosure.

Contrary to the July proposal, the new rules retain the requirement regarding the reporting of full grant date fair value for each individual equity award in the Grants of Plan-Based Awards Table and the footnote disclosure to the Director Compensation Table.

Companies must comply with the new rules when they provide the disclosure required by Item 402 of Regulation S-K for a fiscal year ending on or after December 20, 2009.

Enhanced Director and Nominee Disclosure

The new rules expand disclosure of the qualifications and past directorships of directors and nominees, as well as the time frame for disclosure of legal proceedings involving executive leadership.[11] Under the new rules, in order to provide investors with more information regarding whether a particular director is an appropriate choice, companies must disclose the following information for each nominee and all directors, including those not up for reelection in a particular year:

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[9] The new rule amends Item 402 of Regulation S-K.

[10] Computed in accordance with FASB's Accounting Standard Codification Topic 718.

[11] The new rule amends Item 401 of Regulation S-K.

- the qualifications, attributes or skills that make the individual eligible to serve as a director;[12]
- a discussion regarding whether certain information led the board or proponent to conclude that the person should serve as a director;
- disclosure about the person's particular areas of expertise or other relevant qualifications (which may cover a period of more than the prior five years); and
- disclosure of any directorships held by each director and nominee at any time during the past five years at public companies (rather than disclosure of only current board memberships).[13]

The new rules also expand the required disclosure of the legal proceedings to which a board nominee has been a party from five years prior to nomination to 10 years prior to nomination (excluding private litigation). In an effort to provide greater insight into director character and competence, the SEC also expanded the list of legal proceedings covered by the rules. These new legal proceedings include:

- 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 to such actions; and
- any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Considerations of Diversity in Nominations

During the SEC's open meeting adopting the new rules, the SEC announced a new rule that was not previously released for comment.[14] Under this rule, companies are required to disclose whether diversity is considered by the nominating committee in nominating directors, and if so, how it impacts the nomination process. Additionally, if the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, the rules require disclosure of how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy.

The SEC declined to define the term "diversity," rather leaving it to the company to define diversity as broadly or narrowly as deemed appropriate.

New Disclosure About Company Leadership Structure

The new rules require disclosure of a company's board leadership structure and its appropriateness to the company at the time of the filing.[15] Companies must disclose whether and why they have chosen to combine or separate the principal executive officer and board chair positions. Notably, the new rules do not favor one leadership structure over the other. In certain circumstances, the rules also require disclosure as to whether and why a company has a lead independent director and the specific role of that director.

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[12] Item 401 of Regulation S-K currently only requires brief biographical information, and Item 407 requires general disclosure about director qualification requirements at a company. The new rules require the additional, required information to be company specific and made with particular attention to the company's business and structure.

[13] The final rules do not require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a committee member, as previously proposed.

[14] The new rule amends Item 407(c) of Regulation S-K.

[15] The new rule amends Item 407 of Regulation S-K.

In keeping with the theme of risk adjustment, the new rules will require companies to assess the board's role in risk oversight and the relationship between the board and senior management in dealing with material risks facing the company. This disclosure requirement allows companies to describe how the board administers its risk oversight function (e.g., through the whole board, through a separate risk committee or through the audit committee).

Expanded Disclosures about Compensation Consultants' Fees and Services

The new rules expand the disclosure required when compensation consultants play a role in the determination of the amount or form of executive or director compensation.[16] These disclosure requirements do not apply when a compensation consultant only assists in determining the amount or form of compensation related to nondiscriminatory plans such as health insurance plans or a 401(k).

If the board, compensation committee or other persons performing the equivalent functions have engaged their own compensation consultant to provide advice or recommendations on the amount or form of executive and director compensation, and the compensation consultant (or its affiliate) provides other non-executive compensation consulting services to the company in an amount in excess of $120,000 during the company's last fiscal year, then the company must disclose:

- the aggregate fees for determining or recommending the amount or form of executive and director compensation; and
- the aggregate fees for such other non-executive compensation consulting services.

In addition, the company must disclose whether the decision to engage the compensation consultant for the non-executive compensation consulting services was made or recommended by management and whether the compensation committee or the board approved such other services.

If the board, compensation committee or other persons performing the equivalent functions have not engaged a compensation consultant, but management has engaged a compensation consultant to provide advice or recommendations on the amount or form of executive and director compensation, and the compensation consultant (or its affiliate) provides other non-executive compensation consulting services to the company in an amount in excess of $120,000 during the company's last fiscal year, then the company must disclose:

- the aggregate fees for determining or recommending the amount or form of executive and director compensation; and
- the aggregate fees for such other non-executive compensation consulting services.

For those companies where the compensation committee and management have separate compensation consultants, no disclosure requirement is triggered for services provided by management's compensation consultant, regardless of whether those services related to executive or director compensation.

Current Reporting of Voting Results

The rules require current reporting on Form 8-K of the results of any vote taken at a shareholder meeting, eliminating this requirement from Forms 10-Q and 10-K in order to have more timely disclosure of voting

[16] The new rule also amends Item 407 of Regulation S-K.

results.[17] The SEC reasoned that, if a matter is important enough to submit to a vote, it likely is important enough to warrant current reporting of the results on Form 8-K. Reporting of the results of a shareholder vote must occur within four business days after the end of the meeting at which the vote was held.

The change to Form 8-K includes an instruction that if the matter voted on at the meeting relates to a contested election of directors and the voting results are not definitively determined at the end of the meeting, the company should report the preliminary voting results within four business days after they are determined. The company would then need to file an amended report within four business days after the final voting results are certified.

Other Compensation Disclosure Considerations

The SEC has not limited its recent discussion of the CD&A exclusively to the new Proxy Disclosure Rules. Shelley Parratt, deputy director of the SEC's Division of Corporate Finance, emphasized in a recent speech the importance of better disclosure regarding the compensation of top executives.[18] Citing the increased scrutiny of executive compensation practices at public companies, Parratt stressed the importance of clear and effective disclosure throughout a company's entire CD&A. Further, Parratt made clear that a company waiting to receive staff comments to comply with disclosure requirements should be prepared to amend its filings if it does not materially comply with the rules. In other words, the SEC expects full compliance with the CD&A disclosure rules first announced in 2007.

Parratt's speech urged companies to focus on making disclosure more meaningful and understandable and gave several concrete suggestions for companies to use in improving the quality of their CD&A disclosure. For example:

- explanations of compensation decision-making processes should include why the company made the decisions it made, any specific performance-based targets used or, if not disclosed, any explanation of why disclosure would cause the company competitive harm; and
- companies referring to a peer group used for benchmarking purposes must disclose the names of the peer group companies, why they were selected and where the actual awards fell relative to the benchmarks.

Next Steps for Companies

Given the relatively short effective date and the extent of information companies will need to analyze and discuss in light of the new disclosure requirements, the coming months will be particularly busy for companies and their boards. Among the things companies might consider addressing immediately are:

- revising director and executive officer questionnaires to ensure that information regarding past legal proceedings and past directorships is disclosed;
- assessing the company's policy for risk assessment, if any, and considering the possibility of putting such a policy in place;

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[17] Currently, Item 4 of Part II in Form 10-Q and Item 4 in Form 10-K require the disclosure of the results of any matter that was submitted to a vote of shareholders during the covered fiscal period.

[18] Shelley Parratt, Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010, Nov. 9, 2009, available at http://www.sec.gov/news/speech/2009/spch110909.htm (hereafter Shelley Parratt speech).

- determining whether the enhanced compensation consultant disclosures will apply and what processes would effectively gather information on all the roles filled by the compensation consultant across the company and its affiliates;
- assessing the board leadership structure and any board policies for consideration of diversity in board composition; and
- revising its determination with regard to named executive officers and whether the change in stock award disclosure will affect who is named.

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If you have any questions about this alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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