
SEC Adopts Compensation, Corporate Governance and Risk Disclosure Changes

2009-12-18

On December 16, 2009, by a 4-1 vote, the SEC adopted new rules mandating increased disclosure about a public company's compensation, corporate governance and risk policies and practices. The new rules have an effective date of February 28, 2010, with changes to the compensation tables applying for fiscal years ending on or after December 20, 2009.¹

The SEC's release discussing the new rules is available [here](#).

Overview

The new rules require enhanced disclosure in the following areas:

- compensation policies and practices for all employees as they relate to risk management practices and risk-taking incentives;
- qualifications and experience of directors and director nominees, involvement in legal proceedings and other directorships held by the directors;
- how diversity is considered in the director nomination process;
- the board's leadership structure and the board's role in the oversight of risk; and
- services provided to the company by compensation consultants.

In addition, the new rules will require:

- the summary compensation table and the director compensation table to include the aggregate grant date fair value of stock and option awards; and
- prompt reporting of shareholder voting results on Form 8-K.

Risks Arising from Compensation Policies and Practices

Under the new rules, to the extent that risks arising from a company's compensation policies and practices for its employees are "reasonably likely to have a material adverse effect" on the company, the company must provide disclosure about how these policies and practices relate to risk

management practices and risk-taking incentives. The disclosures will cover policies and procedures for all employees, including non-executive officers. This new disclosure will not be part of Compensation Discussion and Analysis (CD&A), but instead will appear in a new separate section. The adopting release notes, however, that CD&A may still need to discuss how compensation policies or decisions for named executive officers relate to risk. Companies meeting the definition of a "smaller reporting company" are not required to provide the new disclosure.

The "reasonably likely to have a material adverse effect" standard used in the final rule differs from the "may have a material effect" standard the SEC initially proposed. In response to a question from Commissioner Casey during the open meeting held to adopt the new rules, Director of the Division of Corporation Finance Meredith Cross stated that the "reasonably likely" standard is intended to parallel the disclosure threshold used in Management's Discussion and Analysis, and that the addition of the term "adverse" is meant to make clear that the new rules do not require companies to disclose how material compensation policies and practices may help the company.

The adopting release notes that in some circumstances, such as where companies have effective mitigating controls, companies may appropriately conclude that their compensation policies and practices do not create risks that are reasonably likely to have a material adverse effect. In these cases, the adopting release makes clear that no disclosure will be required, and companies need not make any affirmative statement regarding the absence of a reasonable likelihood of a material adverse effect.

Compensation Table Disclosure of Equity Awards

Under the new rules, the summary compensation table and the director compensation table must report the aggregate grant date fair value of equity awards granted during the fiscal year, computed in accordance with FASB ASC Topic 718 (formerly FAS 123R). The SEC believes that this change from the prior rule (which only required the company to include the dollar amount recognized during the fiscal year for financial reporting purposes) will better reflect compensation committee decisions. In preparing the tables for 2009 compensation, companies must recalculate values for 2007 and 2008 using the new rules, although there will be no requirement to re-determine the "named executive officers" listed in the tables for the prior years based on the recalculated values.

In a change from the proposed rules, the grant date fair value of performance awards required to be reflected in the tables will be based on the expected probable outcome of the awards. The new rules will also require footnote disclosure of the maximum potential grant date valuation.

The SEC did not adopt the suggestion of some commenters to change the tables to reflect awards granted with respect to a fiscal year, even if the grant was made after the year ended. Therefore, the compensation tables will continue to be limited to awards granted during the fiscal year being reported on. CD&A will still need to discuss executive compensation actions taken after fiscal year end when those actions could affect a fair understanding of the named executive officers' compensation for the last fiscal year.²

Director and Nominee Qualifications and Experience

Disclosure about directors and nominees will be enhanced on a person-by-person basis to include the specific experience, qualifications, attributes or skills that the board took into account in determining that the individual should serve as a director of the company. This disclosure will be required for all directors, whether up for reelection or not, and, if material, should cover more than the past five years. Disclosure will also be required regarding any directorships held at public companies and registered investment companies at any time during the past five years, even if the director or nominee no longer serves on that board. The final rules did not adopt the proposal to require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a committee member.

The time period for which director, nominee and executive officer legal proceeding disclosure is required will be lengthened from five to ten years. The legal proceedings covered under this disclosure will be expanded to include:

- judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;
- judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws; and
- disciplinary action imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Disclosure regarding private civil litigation will not be required.

Consideration of Director Diversity

Companies will be required to disclose whether and, if so, how their nominating committee considers diversity in identifying nominees. If a company's nominating committee has a diversity policy, the company must disclose how the nominating committee implements the diversity policy and how the nominating committee assesses the effectiveness of its diversity policy. The SEC does not define the term "diversity." As explained in the adopting release, companies may define diversity as appropriate for them, which may include a variety of factors such as differences of viewpoint, professional experience, education, skill, other individual qualities and attributes, race, gender and national origin.

Board Leadership Structure

Companies will be required to discuss the board's leadership structure, such as whether and why the board has chosen to combine or separate the principal executive officer and board chair positions, whether the company has a lead independent director and why the board leadership

structure is appropriate given the company's specific characteristics or circumstances. The adopting release also clarifies that this new disclosure focuses on board leadership, not management leadership. The adopting release reiterates the SEC's position that these disclosures "are not intended to influence a company's decision regarding its board leadership structure."

Board's Role in Risk Oversight

Disclosure will be required regarding the board's role in the oversight of risk, whether through the whole board, a risk committee or the audit committee. The new rules refer to "risk oversight" rather than the proposed "risk management" to more appropriately reflect the board's role.

Compensation Consultants

To enable shareholders to better assess potential conflicts of interest when evaluating executive compensation, companies will be required to disclose whether their board or compensation committee's compensation consultant provides other services to the company and, if so, the fees paid for the compensation consulting services and the additional services. If the board or compensation committee does not have its own consultant, disclosure about the company's compensation consultant is required. A de minimis exception of \$120,000 will apply to the new requirement to provide disclosure about fees paid to compensation consultants for other work.

If a compensation consultant hired by the board or compensation committee performs non-executive compensation consulting work for the company, the new rules also require disclosure as to management's role in the decision to hire the compensation consultant for the other services and whether the board approved the arrangement.

Disclosure regarding fees to compensation consultants who only provide non-customized survey data or consulting about broad-based plans that do not discriminate in favor of officers (such as broad-based 401(k) or health insurance plans) will not be required. In addition, in a change from the proposed rules, the final rules do not require disclosure of the nature and extent of the additional services provided by the compensation consultant to the company.

Prompt Shareholder Voting Disclosure

Under new Form 8-K Item 5.07, shareholder voting results will be required to be reported within four business days after the end of the shareholder meeting. If determination of a final result is uncertain, companies must report preliminary results on the 8-K, and amend the filing once final results are known. If the company believes that the preliminary results may not be indicative of the final results, the company may provide additional disclosure to that effect.

Impact on Investment Companies

Some of the new rules apply to registered investment companies. Registered investment

companies will be required to provide additional disclosures in proxy statements and statements of additional information regarding director and nominee qualifications; past directorships held by directors and nominees; legal proceedings involving directors, nominees and executive officers to funds; and new disclosure about leadership structure and the board's role in the oversight of risk. In addition, registered investment companies will be required to provide additional disclosures about consideration of director diversity in proxy statements.

Dissenting View

While indicating support for most of the new rules, Commissioner Casey voted against adoption due to her opposition to the new disclosure requirements regarding the background and experience of directors and director nominees and diversity. Commissioner Casey said these new disclosures would be burdensome to companies without providing a commensurate benefit to investors because they will not provide meaningful information. In particular, she criticized the person-by-person focus of the new disclosure requirement, which she said ignored the reality that many boards make decisions based on the overall composition of the board. Commissioner Casey expressed concern that these new rules have the potential of disrupting the way boards approach decisions about nominations and might inappropriately encroach on the board's decision making role.

Action on Proxy Solicitation Rules Deferred

The SEC deferred action on the proxy solicitation rule changes that it had included in the proposing release. During the open meeting, Chairman Schapiro indicated that she expected action would be taken on proxy solicitation rules in 2010.

¹ The adopting release is otherwise silent regarding implementation dates for the new rules. The SEC Staff has published additional implementation guidance, available [here](#) for operating companies and [here](#) for investment companies. The Staff's guidance states that if a company's fiscal year ends on or after December 20, 2009, its Form 10-K (or, for an investment company, its registration statement) and proxy statement must comply with the new rules if filed on or after February 28, 2010. If such a company files its 2009 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. In addition, if such a company is required to file a preliminary proxy statement and expects to file its definitive proxy statement on or after February 28, 2010, then the preliminary proxy statement must comply with the new rules, even if filed before February 28, 2010.

If a company's fiscal year ends before December 20, 2009, its 2009 Form 10-K (or, for an investment company, its registration statement) and related proxy statement do not need to comply with the new rules, even if filed on or after February 28, 2010.

The interpretations also provide implementation guidance about Securities Act registrations statements, the new Form 8-K requirement and other matters.

2 The SEC did not adopt its proposal to eliminate the requirement to report the full grant date fair value on an award-by-award basis in the grants of plan-based awards table and the director compensation table, and it did not adopt its proposal to change the reporting of salary or bonus forgone at a named executive officer's election.

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