WILMERHALE

SEC Proposes Expanded Compensation and Governance Disclosure Rules

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Noting that the market turmoil of the past 18 months has "reinforced the importance of enhancing transparency, especially with regard to activities that materially contribute to a company's risk profile," on July 10 the Securities and Exchange Commission released proposed rule amendments to enhance the compensation and corporate governance disclosures that public companies are required to make. The proposed new disclosures address:

- a company's overall compensation policies and the impact of such policies on risk taking;
- reporting of the value of stock and option awards of executives and directors;
- director and nominee qualifications and legal proceedings affecting them and executive officers;
- company leadership structure;
- the board's role in the risk management process; and
- potential conflicts of interest of compensation consultants.

In addition, the proposed amendments would accelerate the timing for public companies to disclose the results of shareholder votes.

These proposals, if adopted, will likely impose additional disclosure burdens on reporting companies. In particular, the new compensation disclosure requirements may require significant additional work because the required disclosure will be expanded to include non-executive compensation policies and practices and to require a detailed risk assessment with respect to those policies and practices.

If adopted, the amendments are expected to be effective for the 2010 proxy season. Comments on the proposed rules are due by September 15, 2009.

Compensation Disclosure

Compensation Policies and Procedures, Risk and Risk Management

The SEC proposes to expand Compensation Discussion and Analysis (CD&A) to address a company's overall compensation program as it relates to the company's risk management. Currently, CD&A is focused on compensation policies and practices affecting a company's named executive officers (determined according to Item 402(a) of Regulation S-K). In proposing these amendments, the SEC observes that broader compensation policies and overall compensation practices for employees generally could also be important if risks arising from those compensation policies or practices may have a material effect on the company. Accordingly, the new rule would require that "[t]o the extent that risks arising from the registrant's compensation policies and overall actual compensation practices for employees generally may have a material effect on the registrant," the company must "discuss the registrant's policies or practices of compensating its employees, including non-executive officers, as they relate to risk management practices and/or risk-taking incentives." Noting that situations requiring disclosure will vary depending on the company and its policies, the SEC identifies as situations that could trigger discussion and analysis, among other things, compensation policies and practices:

- at a business unit that carries a significant portion of the company's risk profile;
- at a business unit with compensation structured significantly differently than other units within the company;
- at a business unit that is significantly more profitable than others within the company;
- at a business unit where the compensation expense is a significant percentage of the unit's revenues; or
- that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

The proposed rule includes several illustrative examples of issues that the registrant may need to address if material (under the same materiality threshold that applies generally to CD&A). These include:

- the general design philosophy of the company's compensation policies for employees whose behavior would be most impacted by the incentives established by the policies, as such policies relate to or affect risk taking by those employees on behalf of the company, and the manner of implementation;
- the company's risk assessment or incentive considerations in structuring its compensation policies or 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 and long term, such as through policies requiring claw backs or imposing holding periods;
- the company's policies regarding adjustments to its compensation policies to address changes in its risk profile;
- material adjustments the company has made to its compensation policies or practices as a result of 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.

Compensation Table Disclosure of Value of Stock Awards

The proposed amendments would revise the Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards to require disclosure of the aggregate grant date fair value of awards computed in accordance with Statement of Financial Accounting Standards No. 123R. Under the current rules, the tables require disclosure of the dollar amount recognized for financial reporting purposes in the fiscal year in question.[1] The SEC states in partial explanation that investors may consider compensation decisions made during the fiscal year – which usually are reflected in the full grant date fair value measure, but not the financial statement recognition measure – to be material to voting and investment decisions, and notes that some companies were already providing such information voluntarily in an alternative summary compensation table. The SEC adds that, if a company does not believe that full grant date fair value reflects a named executive officer's compensation, it can provide appropriate explanatory narrative disclosure. As the proposed amendments bring this information into the Summary Compensation Table rather than the Grants of Plan-Based Awards Table (which smaller reporting companies are not currently required to provide) the amendments would also make this award information available to smaller reporting company investors.

As part of adopting this change to stock and option award disclosure, the proposed amendments would also:

- rescind the requirement to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table and corresponding footnote disclosure to the Director Compensation Table because these disclosures would be duplicative of the aggregate grant date fair value disclosure to be provided in the Summary Compensation Table; and
- amend the instruction to the salary and bonus columns of the Summary Compensation Table to provide that companies will not be required to report in those columns the amount of salary or bonus forgone at a named executive officer's election, and that non-cash awards received in the place of salary or bonus are instead reportable in the column applicable to the form of award elected, making the disclosure reflect the form of compensation received by the named executive officer.

Director and Nominee Disclosure

Director and Nominee Qualifications and Experience

The SEC is proposing to expand the disclosure requirements regarding the qualifications of directors and nominees for director. The proposed amendments would require disclosure detailing for each director and nominee the particular experience, qualifications, attributes or skills that qualify that person to serve as a director of the company, and as a member of any committee that the person serves on or is chosen to serve on (if known), in light of the company's business and structure. The proposed amendments would expand the information required about individual

directors beyond the current five-year requirement and supplement the current disclosures about general director independence required by Item 407 of Regulation S-K. The type of information that may be disclosed includes, for example, information about a director's or nominee's risk assessment skills and any specific past experience that would be useful to the company, as well as information about a director's or nominee's particular area of expertise and why the director's or nominee's service as a director would benefit the company at the time at which the relevant filing with the SEC is made. This expanded disclosure would apply to incumbent directors, to nominees for director who are selected by a company's nominating committee, and to any nominees put forward by other proponents.

Director and Nominee Past Directorships and Legal Proceedings

The proposed amendments would require disclosure of any directorships held by each director and nominee at any time during the past five years at public companies. Currently, companies are required to disclose any current director positions held by each director and nominee in public reporting company or registered investment company. The SEC believes that expanding this disclosure to include membership on such corporate boards for the past five years (even if the director or nominee no longer serves on that board) would allow investors to better identify professional or financial relationships that might pose potential conflicts of interest, such as membership on boards of major suppliers, customers or competitors. In addition, the proposed amendments would lengthen from five years to 10 years the time period under Item 401(f) for disclosure of certain legal proceedings involving directors, nominees or executive officers.

The proposed amendments would apply the expanded disclosure requirements regarding director and nominee qualifications, past directorships held by directors and nominees, and the time frame for disclosure of legal proceedings involving directors, nominees, and executive officers to management investment companies that are registered under the Investment Company Act. The proposal would amend the disclosure requirements of Schedules 14A and 14C to apply these expanded requirements to fund proxy and information statements where action is to be taken with respect to the election of directors. It would also amend Forms N-1A, N-2, and N-3.

Leadership Structure and the Board's Role in the Risk Management Process

The proposed amendments would require disclosure of the company's leadership structure and why the company believes that the structure is the best one for it at the time of the filing. Companies also would be required to disclose whether and why they have chosen to combine or separate the principal executive officer and board chair positions. Companies that have combined the role of the principal executive officer and board chair would be required to disclose whether they have a lead independent director and specify the role the lead independent director plays in the leadership of the company. The SEC notes that it is not intending to influence a company's decisions regarding board leadership structure. In the release, the SEC states that different leadership structures may be suitable for different companies, depending on a range of factors, and that, regardless of the type of leadership structure selected, the disclosure would provide investors with insights about why a

company has chosen that particular leadership structure.

The proposed amendments also would require additional disclosure in proxy and information statements about the board's role in the company's risk management process and whether and how the board, or a board committee, monitors risk.[2] According to the SEC, such disclosure might address questions such as whether the persons who oversee risk management report directly to the board as a whole, to a committee, such as the audit committee, or to one of the other standing committees of the board, and whether and how the board or board committee monitors risk.

As with the expanded disclosure under Item 401, the SEC is proposing that registered management investment companies provide the new disclosure about leadership structure and the board's role in the risk management process in proxy and information statements. It has tailored the disclosure requirements to the management structure of funds by requiring that a fund disclose whether the board chair is an "interested person" of the fund, as defined in Section 2(a)(19) of the Investment Company Act, and that if the board chair is an interested person, a fund disclose whether it has a lead independent director and what specific role the lead independent director plays in the leadership of the fund.

Compensation Consultants

The SEC proposes amendments to address the concern that, in addition to providing executive compensation consulting services, many compensation consultants, or their affiliates, provide a broad range of additional services (such as benefits administration, human resources consulting and actuarial services) generating significant fees and that these fees could create the appearance, or risk, of a conflict of interest that may call into question the objectivity of the consultants' executive pay recommendations. Proposed amendments would require disclosure about the fees paid to compensation consultants and their affiliates when they play any role in determining or recommending the amount or form of executive and director compensation, if they also provide other services to the company. These proposed amendments also would require a description of any additional services provided to the company by the compensation consultants and any affiliates of the consultants. Under circumstances where a compensation consultant is both playing a role in determining or recommending the amount or form of executive and director compensation and also provide other services to the company, companies would be required to disclose the following:

- the nature and extent of all additional services provided to the company or its affiliates during the last fiscal year by the compensation consultant and any affiliates of the consultant;
- the aggregate fees paid for all additional services, and the aggregate fees paid for work related to determining or recommending the amount or form of executive and director compensation;
- whether the decision to engage the compensation consultant or its affiliates for non-executive compensation services was made, recommended, subject to screening or reviewed by management; and

- whether the board of directors or the compensation committee has approved all of these services in addition to executive compensation services.

The proposed amendments would not apply to those situations in which the compensation consultant's only role in recommending the amount or form of executive or director compensation is in connection with consulting on broad-based plans that do not discriminate in favor of executive officers or directors of the company, such as 401(k) plans or health insurance plans.

Shareholder Voting

The proposed amendments would accelerate the timing for public companies to disclose the results of shareholder votes. Currently, this information is required to be disclosed in the Form 10-Q or Form 10-K report covering the quarterly period in which the vote was taken. Under the proposal, a registrant would instead be required to report the results on Form 8-K within four business days after the vote was taken, except in the case of contested votes, in which case the registrant would be required to report preliminary results within four business days after the vote and final results within four business days after they are certified. In addition, the proposed amendments seek to address various interpretive issues under the proxy rules to clarify certain issues relating to the solicitation of proxies and granting of proxy authority.

[1] As originally adopted, the SEC's September 2006 executive compensation disclosure rules required that the Summary Compensation Table and Director Compensation Table include the aggregate grant date fair value of stock and option awards. In December 2006, the SEC modified the rule to require disclosure only of the amount of compensation expense recorded in the particular fiscal year, rather than the total fair value of the grant. The proposed amendment would reverse the December 2006 amendment. The SEC offers several explanations for the reversion, stating initially that it believes "the current method for presenting this information may have inadvertently resulted in investor confusion" and re-examining the original reasons for the December amendment to explain its conclusion that the goals of "clear, concise and meaningful executive compensation disclosure would be better served by amending the Summary Compensation Table." As originally adopted, the SEC's September 2006 executive compensation disclosure rules required that the Summary Compensation Table and Director Compensation Table include the aggregate grant date fair value of stock and option awards. In December 2006, the SEC modified the rule to require disclosure only of the amount of compensation expense recorded in the particular fiscal year, rather than the total fair value of the grant. The proposed amendment would reverse the December 2006 amendment. The SEC offers several explanations for the reversion, stating initially that it believes "the current method for presenting this information may have inadvertently resulted in investor confusion" and re-examining the original reasons for the December amendment to explain its conclusion that the goals of "clear, concise and meaningful executive compensation disclosure would be better served by amending the Summary Compensation Table."

[2] The SEC notes that companies face different kinds of risk, including credit risk, liquidity risk, and operational risk, and that given the role that risk and the adequacy of risk oversight have played in

the recent market crises, it believes it is important for investors to understand the board's or board committee's role in this area.

Authors

Thomas W. White

RETIRED PARTNER

+1 202 663 6000

Knute J. Salhus

RETIRED PARTNER

knute.salhus@wilmerhale.com

+1 212 230 8800

Jonathan Wolfman

PARTNER

Co-Chair, Corporate Governance and Disclosure Group

jonathan.wolfman@wilmerhale.com

+1 617 526 6833