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SEC Proposes Amendments to Enhance Compensation and Corporate Governance Disclosure

On July 10, 2009, the SEC issued proposed regulatory amendments to enhance compensation and corporate governance disclosure in proxy statements, registration statements, and regulatory forms, effective for the 2010 proxy season. The proposed amendments would require a new section in the Compensation Discussion and Analysis (CD&A) covering compensation policies and practices for employees (not limited to named executive officers) if risks associated with those policies and practices could have a material effect on the company. The proposed amendments would also change the method of disclosing the value of stock and option awards in the Summary Compensation Table (SCT) and the Director Compensation Table. Further, the proposed amendments would require new disclosures regarding a company's leadership structure, the board's role in the risk management process, director and nominee qualifications and involvement in legal proceedings, and additional services performed by compensation consultants and their affiliates and associated fees.

Background

For several years, the SEC has been engaged in rulemaking initiatives to improve the transparency of executive officer and director compensation so that investors can make informed voting and investment decisions. In response to over 20,000 comment letters on proposed rules, the SEC issued significant proxy disclosure and related rules in 2006 (see our October 18, 2006 *For Your Information*) and later issued interpretive guidance (see our February 6, 2007 *For Your Information*).

The turmoil in the financial markets has again brought executive compensation disclosure to the forefront of the SEC's rulemaking agenda, with a renewed focus on enhancing transparency and the alignment of executive compensation and corporate governance practices to risk management. Now the SEC has published new proposed disclosure rules that are intended to inform investors whether incentives and corporate governance practices might lead to excessive or inappropriate risk taking.

> ***BUCK COMMENT.*** *Notably, the SEC has solicited extensive comments in the form of specific pointed questions on each section of the proposed rules. Comments are due by September 15, 2009.*

SEC Proposed Amendments

Enhanced Compensation Disclosure

Expanded Compensation Discussion and Analysis Section (CD&A). The CD&A section of the proxy relies on principles-based disclosure of material elements of a company's compensation programs for its named executive officers. The CD&A provides a narrative discussion and analysis that puts into context other required disclosures, such as data presented in the tables.

The proposed rules would include a new section in the CD&A. In the new section, a company would be required to discuss and analyze in narrative format its broader compensation policies and practices for employees, including non-executive officers, but only if "risks arising from those compensation policies or practices may have a *material effect* on the company." The SEC gives examples of situations that could potentially trigger discussion and analysis, including 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 policies structured significantly differently than other business units
- at business units that are significantly more profitable than other business units within the company
- at business units where compensation expense is a significant percentage of the unit's revenue
- 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 list above is non-exhaustive and is based on a facts and circumstances analysis. Disclosure is only required where the company itself determines that the materiality threshold is triggered.

> ***BUCK COMMENT.*** *Although the illustrative examples above are helpful, further guidance on what is "material" for this purpose would be welcome. The SEC has solicited specific comments asking whether the examples are appropriate, the new rules should be limited to companies of a particular size or industry (such as the financial sector), and a statement should be required by companies that conclude that disclosure is not required because the materiality threshold has not been met.*
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> *Within this context, a critical issue that companies and their compensation committees will be facing is the potential tension between incentives designed to motivate employees to achieve specific performance goals and long-term value creation. While "line of sight" performance measures are fundamental to driving performance, a proper analysis and understanding of whether they will also create sustained value over the long term for the enterprise as a whole is necessary.*

In addressing this new disclosure requirement and what the CD&A narrative might include, the SEC provides further illustrative examples of the types of issues that companies may need to address –

- the general design philosophy of the compensation policies for employees whose behavior would be most affected by the incentives, i.e., whether such policies might affect risk taking, and how the philosophy is implemented
- a company's risk assessment or incentive considerations, if any, in structuring its compensation policies or awarding compensation
- how the policies relate to the risks in both the short term and long term, such as through policies requiring claw backs or imposing holding periods
- a company's policies regarding adjustments to its compensation policies or practices as a result of changes in a company's risk profile
- material adjustments that have been made to the company's compensation policies or practices as a result of changes in its risk profile
- the extent to which a company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

> ***BUCK COMMENT.*** *These proposed amendments underscore the challenges facing companies and their compensation committees, the unprecedented complexities surrounding the pay-setting process, and the need to continuously monitor compensation arrangements. (See Buck's* InsightOut *publication entitled* Corporate Governance – A Risk Sensitized Executive Pay Governance Process *(*Part One & Part Two*)).*

Summary Compensation Table (SCT) and Director Compensation Table - Stock and Option Award Disclosure. The proposed rules would require the value of stock and option awards disclosed to be determined using the aggregate grant date fair value under FAS 123R rather than the current dollar amount for financial statement reporting purposes for the fiscal year. The SEC believes that investors may consider compensation decisions made during the fiscal year – which typically are based on the full grant date fair value measure and not the financial statement recognition measure of such equity award – to be material to voting and investment decisions.

> ***BUCK COMMENT.*** *This change reverses the SEC position taken in December 2006 (see our January 9, 2007* For Your Information*) and will provide for more meaningful information. As the SEC notes, some companies have already adopted the proposed revised standard by including an alternative SCT – substituting full grant date fair value in the stock and option awards columns – in addition to the SCT disclosures required under the current rules.*

A company that believes the new full grant date fair value method would not accurately reflect a named executive officer's compensation could provide a narrative disclosure. The proposed amendments would 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 in the footnote disclosure to the Director Compensation Table, as it would be duplicative under the new rules.

This new method of presentation would include the disclosure of the incremental fair value of options repriced during the fiscal year. The new proposed rules would also amend Instruction 2 to the salary and bonus column of the SCT to provide that salary or bonus forgone at a named executive officer's affirmative election need not be disclosed in those columns. Non-cash awards received instead of salary or bonus would be reportable in the applicable column of the form of award elected (i.e., Stock Awards, Option Awards, All Other Compensation). Under the proposed rules, all stock and option awards would be reported in the SCT at full grant date fair value, including awards with performance conditions.

The SCT requires disclosure for each of the company's last three fiscal years. The SEC's stated goal is to facilitate consistent year-to-year comparisons and is therefore considering whether to require disclosure for a fiscal year ending on or after December 15, 2009, to present recomputed disclosure for each preceding fiscal year required to be included in the SCT. The Stock Awards and Option Awards columns would present full grant date fair value, including for prior fiscal years, and Total Compensation would be recomputed accordingly. Although compensation would be required to be recomputed for prior years, the SEC is not proposing that different named executive officers be identified based on the recomputed compensation. The SEC has solicited comments on this issue.

Enhanced Corporate Governance Disclosure

Director and Nominee Disclosure. The SEC is proposing amendments to Item 401 of Regulation S-K to expand the disclosure requirements to include the relevant experience and qualifications of directors and nominees and other directorships held. Currently, Item 401 only requires brief biographical information for the past five years. Under the proposed rules, an expanded narrative disclosure of qualifications would be required to include the experience, qualifications, and skills that qualify the person to serve as director. This might include accounting or finance skills, risk assessment skills, the director's area of expertise, and why the director's service would benefit the company. In addition, any directorships held at any time during the past five years at public companies would have to be disclosed to allow investors to evaluate professional or financial relationships that could potentially pose conflicts of interest, e.g., membership on boards of suppliers, customers, or competitors. The SEC is also considering whether diversity in the boardroom is an area requiring disclosure, and has solicited comments on this issue.

The proposed rules would also increase the applicable time frame from five to ten years for disclosure of any legal proceedings involving the directors, nominees, or executive officers. The SEC has solicited comments on whether the disclosure of the legal proceedings requirement should be for an even longer period (e.g., 15 or 20 years, or indefinitely).

New Disclosure of Company Leadership and Board Role in Risk Management Process. The SEC is proposing new rules requiring disclosure of the company's leadership structure to increase the transparency for investors as to how boards function. In particular, the SEC would require disclosure of whether the principal executive officer and board chair roles are combined or separate. If the roles are separate, the SEC would require disclosure of whether there is a lead independent director and the specific role the lead independent director plays in leading the company. The SEC is also proposing disclosure regarding the board's role in the company's risk management process, including credit, liquidity and operational risks. For example, the SEC would require disclosure regarding how the board implements and manages its risk management function, i.e., through the board as a whole or through a committee (such as the audit committee) and how the board monitors those risks. This rule is also being proposed for mutual fund companies, but has been tailored to require the disclosure to specify whether the board chair is an "interested person" of the fund.

New Disclosure of Consulting Fees to Compensation Consultants and Affiliates. In addition to executive compensation consulting, some compensation consultants and their affiliates provide additional services to the same company, such as benefits administration, human resources consulting or actuarial services, which could generate significant fees. In such case, the SEC is proposing disclosure of such additional services and the fees paid to consultants and their affiliates when they play a role in determining or recommending the amount or form of executive and director compensation. Specifically, the proposed rules would require disclosure of the nature and extent of any additional services, the aggregate fees, whether the decision to engage the compensation consultant or affiliates for non-executive compensation services was subject to review by management, and whether the board or compensation committee approved the additional services. If the consulting is limited exclusively to broad-based plans such as 401(k) or health plans that cover all salaried employees, including executives, then this new disclosure requirement would not apply.

> ***BUCK COMMENT.*** *The SEC has solicited comments regarding whether the proposed amendments would adversely affect the ability of a company to receive executive compensation or additional consulting services and whether there are proprietary or competitive concerns that should be taken into consideration in the final rules.*

Requests for Comment on Other Topics

The SEC has invited interested persons to submit comments on the advisability of any of the proposed reforms, as well as to provide other approaches. In addition, the SEC has solicited comments specifically on whether –

- any current proxy disclosures should be eliminated
- disclosure should be required of compensation paid to each executive officer, rather than the current requirement of just named executive officers

- the instruction should be eliminated that provides that performance targets can be excluded based on the potentially adverse competitive effect of the public disclosure on the company
- the CD&A requirement should be revised to require disclosure of performance targets after the performance related to the award is measured (e.g., three or more fiscal years later) and whether this disclosure would create competitive harm
- disclosure should be required regarding compensation committee members' expertise in compensation matters, if any, and the availability of resources to hire independent counsel on behalf of the committee
- tabular and narrative disclosure requirements should be amended to include claw backs and "hold to retirement" provisions
- disclosure should be expanded to include discussion of internal pay equity, total number and features of compensation plans, and the savings to each executive officer as a result of tax gross-up arrangements, if any.

Conclusion

As was the case in 2006, these new proposed rules will likely spur many comments to the SEC which will undoubtedly influence the final rules. Buck's consultants are tracking the rapid developments in this area and are available to discuss your current compensation and governance practices and concerns.