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SEC Finalizes Amendments to Enhance Compensation and Corporate Governance Disclosure

On December 16, 2009, the Securities and Exchange Commission (SEC) released final amendments to its disclosure rules to enhance compensation and corporate governance disclosures in proxy and information statements, annual reports, and registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933 and the Investment Company Act of 1940. Also under the amendments, the requirements to report shareholder voting results are being transferred from Forms 10-Q and 10-K to Form 8-K.

Background

On July 17, 2009, the SEC proposed significant amendments to its proxy filing disclosure rules aimed at enhancing the adequacy and transparency of information provided to shareholders and other investors of publicly held companies. (See our July 20, 2009 *For Your Information*). The SEC received over 130 comment letters (including a letter from Buck) and, after consideration of many of the concerns expressed, has now issued final amendments, generally effective February 28, 2010. Just released transition guidance indicates that if the company's fiscal year ends before December 20, 2009, its 2009 Form 10-K and related proxy statement are not required to be in compliance with the new proxy disclosure requirements, even if filed on or after February 28, 2010. Some highlights of the amendments follow.

Highlights of Final Amendments

Enhanced Compensation Disclosure

Narrative Disclosure of Compensation Policies and Practices as they Relate to Risk Management. The SEC's final amendments require companies to disclose, in a separate section, their compensation policies and practices for all employees, including non-executive officers, but only if the risks arising from those compensation policies or practices "are reasonably likely to have a material adverse effect on the company." Under the proposed rules, this disclosure would have been part of the Compensation Discussion and Analysis (CD&A) and would have been required if the policies and practices "may have a material effect on the company." Basically, the SEC determined that the "reasonably likely" disclosure threshold applicable to its Form 10-K filing rules involving the Management Discussion and Analysis (MD&A) would be appropriate. The SEC also indicated that the "reasonably likely" threshold addresses concerns that the proposed requirements would have caused overly burdensome and voluminous disclosure of potentially insignificant and unnecessarily speculative information

about a company's compensation policies. In addition, in using the phrase "material adverse effect," rather than "material effect" as proposed, the SEC acknowledged that well-designed compensation policies can enhance a company's business interests by encouraging innovation and appropriate levels of risk-taking.

The final amendments retain the two non-exclusive lists included in the proposed rules – the first listing situations that could potentially trigger disclosure and the second listing issues that would potentially be appropriate for companies to address.

> ***BUCK COMMENT.*** *While the SEC has relaxed its stance with respect to disclosure of compensation policies and practices as they relate to risk management, it is still incumbent upon companies and their compensation committees to review their existing compensation policies and practices including, but not limited to, annual incentive arrangements, long-term incentives (including equity awards), commission-based plans, severance packages, deferred compensation and supplemental retirement arrangements, and change in control provisions, and assess whether such policies and practices are "reasonably likely to have a material adverse effect" on the company. Most importantly, companies and their committees will need to document the processes in place and the rationales that support their conclusions.*

Consistent with the proposed rules, smaller reporting companies will not be required to provide the new disclosures. Further, the SEC states that the final amendments do not require a company to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

Revisions to the Summary Compensation Table (SCT) and Director Compensation Table – Stock and Option Award Disclosure. The SEC has adopted its proposal that the SCT and Director Compensation Table disclose the grant date fair value of stock awards and option awards computed in accordance with FASB ASC Topic 718 (formerly SFAS 123R). The revisions replace previously mandated disclosure of the dollar amount recognized for financial statement expense reporting purposes for the fiscal year, and will affect the calculation of total compensation, including for purposes of determining who is a named executive officer.

Most commenters agreed that aggregate grant date fair value disclosure better reflects the compensation committee's decisions with regard to stock and option awards. The SEC's view continues to be that even if using the aggregate grant date fair value results in relatively frequent changes in the named executive officer group, because of one-time, multi-year awards, such as new hire or retention grants, investors may consider compensation decisions made during the year to be material to voting and investment decisions. When such a grant results in the omission from the SCT of an executive officer whose compensation otherwise would have been subject to reporting, the company can consider including compensation disclosure for that executive officer to supplement the required disclosures.

> ***BUCK COMMENT.*** *This change in how stock and option awards are to be reported may significantly change the named executive officers that have typically been reported in the SCT. It is not uncommon for large new-hire awards or retention awards to be granted to key employees as a means of attracting and retaining talent.*

In addition, the SEC was persuaded by comments that the value of performance awards reported in the SCT, Grants of Plan-Based Awards Table and Director Compensation Table should be computed based on the probable outcome of performance conditions, rather than maximum performance levels. This is because performance awards are generally designed to incentivize reaching target performance levels and basing values on maximum performance levels tends to overestimate the intended level of compensation. New instructions clarify that amounts should be based on probable outcome. In addition, footnote disclosure of maximum values will be required for the SCT and Director Compensation Table.

Regarding equity award disclosure, the SEC retains its decision not to rescind the requirement to report the full grant date fair value of each equity award in the Grants of Plan-Based Awards Table. In addition, the SEC is requiring disclosure of awards granted during the year, as proposed, as opposed to awards for services provided in the relevant fiscal year. However, the SEC indicated that companies should continue to analyze in the CD&A decisions to grant post-fiscal year end equity awards when those decisions could affect a fair understanding of compensation for the last fiscal year, and should consider including supplemental tables when it facilitates understanding the CD&A.

Enhanced Corporate Governance Disclosure

Director and Nominee Disclosure. The final amendments require enhanced disclosure regarding the qualifications of directors and nominees for director, along with disclosure of directorships held by directors and nominees in the past five years. In addition, the amendments lengthen the time period for disclosure of legal proceedings involving directors, nominees and executive officers from five to ten years and expand the list of legal proceedings that must be disclosed.

Consistent with the proposed rules, the final amendments will require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director. In addition, if the nominating committee (or the board) has a policy with regard to considering diversity in identifying director nominees, disclosure would be required of how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy. The rules do not define diversity, but instead allow companies to define it in ways they consider appropriate.

New Disclosure of Board Leadership Structure and Role in Risk Oversight. The SEC agreed with commenters that using the phrase “board leadership structure” instead of “company leadership structure” would avoid potential misunderstanding. The SEC also agreed with commenters that the phrase “risk oversight” instead of “risk management” would be more appropriate in describing the board’s responsibilities in this area.

Under the amendments, a company is required to disclose whether and why it has chosen to combine or separate the principal executive officer and board chairman positions, and the reasons why the company believes that this board leadership structure is the most appropriate structure for the company. In addition, companies that have a lead independent director are required to disclose whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company.

The final amendments also require companies to describe the board's role in the oversight of risk. The SEC believes that disclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company. The rules give companies flexibility to describe how the board administers its risk oversight function.

New Disclosure of Consulting Fees to Compensation Consultants and Affiliates. The final amendments require disclosure about fees paid to compensation consultants and their affiliates when they play a role in determining or recommending the amount or form of executive and director compensation and also provide additional services to the company. The amendments are intended to provide investors with information to help them assess the potential conflicts of interest that may arise when consultants perform both these roles. These rules are summarized below –

- Disclosure is required if the board has engaged its own consultant to advise on the amount or form of executive and director compensation and the consultant provides other services to the company, provided the fees for the other services exceed $120,000 during the company's fiscal year.
- Disclosure is also required of whether the decision to engage the consultant to provide the other services was made or recommended by management and whether the board approved the other services.
- If the board has not engaged its own consultant, disclosure is required if there is a consultant hired by management who provides both executive compensation consulting and other services to the company, provided the fees for the other services exceed $120,000 during the company's fiscal year.
- Fee and related disclosure for consultants that work with management is not required if the board has engaged its own consultant, regardless of whether or not the consultant working for management provides executive compensation consulting services.
- Services involving only broad-based nondiscriminatory plans or providing information that is not customized for the company (such as surveys), or is customized on parameters that are not developed by the consultant, are not considered executive compensation consulting services for purposes of the disclosure rules.

It should be noted that the final amendments do not require disclosure about the nature and extent of additional services provided by the compensation consultant, as originally proposed.

Conclusion

In addition to satisfying the new disclosure requirements, companies and their compensation committees may have to adopt changes in their policies and practices to fully comply with the new rules. The degree to which changes are required will largely be based on each company's preparedness to develop and implement a risk assessment framework associated with compensation policies and practices. Buck's consultants are available to discuss your proxy disclosures and current compensation and governance practices and concerns and guide you through the actions necessary to assure compliance.