

Management Alert

New Executive Compensation and Corporate Governance Rules for 2010 Proxy Season

On December 16, 2009, the Securities and Exchange Commission (SEC) adopted a series of amendments to the proxy disclosure rules that will:

- Create compensation “risk” disclosure requirements regarding incentive compensation practices;
- Modify how a company calculates the fair value of an equity award;
- Require a company to discuss in its proxy statement all other services rendered to the company by its compensation consultant or its affiliates;
- Create new disclosure requirements discussing the company’s board leadership structure and its risk management policies and procedures;
- Enhance disclosure of director qualifications and diversity; and
- Accelerate the reporting of results of stockholder votes.

A summary of the new rules is set forth below and the text of the SEC’s adopting release for the new rules is available at <http://sec.gov/rules/final/2009/33-9089.pdf>. In addition, the SEC staff has published a series of compliance and disclosure interpretations to address transition reporting which are available at: <http://sec.gov/divisions/corpfm/guidance/pdetinterp.htm>. Except for the rule amendments regarding the reporting of equity compensation awards at grant date fair value, which are effective with respect to Item 402 of Regulation S-K disclosures included in any report for a fiscal period ending on or after December 20, 2009, companies must comply with the new rules in any Form 10-K that is filed with the SEC, or any proxy statement that is filed with the SEC and mailed to stockholders, in each case on or after February 28, 2010.

Compensation Risk Disclosures

The new rules require a company to consider how, if at all, its overall compensation for employees creates incentives that may impact its risk and management of risk. This new disclosure is only required if a company determines that risks arising from its compensation policies and practices for all employees could have a material adverse effect on the company. In this circumstance, a company would need to consider and, where appropriate, disclose the level of risk that any employees may be inclined to take in order to satisfy the incentive-based elements of their compensation packages. In assessing whether disclosure is required, companies also should consider controls and other elements that may mitigate the probability or potential impact of compensation policies that might otherwise create risks.

The SEC suggested that such enhanced disclosure regarding employee compensation may be appropriate in situations where:

- A particular business unit accounts for a significant portion of the company's risk profile;
- The compensation of a particular business unit is structured significantly differently from that of other units;
- A particular business unit is significantly more profitable than other units;
- The compensation expense of a particular business unit represents a significant percentage of the company's revenues; or
- Compensation policies or practices vary significantly from the company's overall risk and reward structure, such as when the timing for performance-based bonuses or incentive awards occurs significantly before receipt of anticipated income or expiration of associated risk to the company.

Although the SEC had proposed the new risk disclosure as a component of the Compensation Discussion and Analysis (CD&A), the SEC determined that the CD&A should remain focused on only executive compensation, and the final rules removed the new risk disclosure from the CD&A and adopted it as a stand alone disclosure item. Accordingly, a company's analysis of the risks arising from its incentive compensation practices will be outside of the scope of the report of its compensation committee required by Item 407(e)(5) of Regulation S-K. In addition, smaller reporting companies will not be required to comply with the enhanced risk disclosure rules.

Equity Compensation Award Reporting

When the SEC last amended its executive compensation disclosure rules in 2006, it adopted rule amendments mandating that an equity compensation award was to be reported in the Summary Compensation Table based on the amount expensed by the company in its financial statements under FAS No. 123(R) for the award. Although this approach minimized the likelihood of year to year fluctuations in compensation levels that could affect the composition of a company's named executive officers from year to year, the FAS No. 123(R) expense amount for an equity compensation award did not accurately reflect the value of the award to the executives. In order to provide investors with this meaningful information, the new rules discontinue fair value reporting of equity awards based on the amount expensed under FAS No. 123(R) and instead require equity compensation awards to be reported in the Summary Compensation Table at the grant date fair value calculated in accordance with FASB ASC Topic 718.

The new rules will apply to all stock and option awards, including performance-based awards. The grant date fair value of a performance-based award must be reported in the Summary Compensation Table based on the probable outcome of the performance condition, assessed as of the grant date of the awards. The maximum potential value for a performance-based award must be disclosed in a footnote to the Summary Compensation Table. In addition, the new rules require all companies to recalculate prior year compensation awards in the Summary Compensation Table to reflect the new rules if the information is being presented in a report or proxy statement relating to a fiscal period ending on or after December 20, 2009.

Compensation Consultants

Under current SEC disclosure rules, a company is required to identify its compensation consultant and describe the role of the compensation consultant in the company's compensation practices. A company is not required to disclose the fees paid to its compensation consultant or any of its affiliates for executive compensation consulting or other services, or to describe services that are not related to executive or director compensation. Affiliates of the compensation consultant would be those persons or entities that control, are controlled by, or are under common control with the compensation consultant.

The new rules will require a company to disclose certain additional information about the fees paid to its compensation consultant and affiliates of the compensation consultant when such consultant or affiliates provide other non-compensation related services. The SEC noted that many compensation consultants, or their affiliates, provide a broad range of additional services, such as benefits administration, human resources consulting and actuarial services and that the provisions of such additional services—for fees that are often more significant than the fees for the compensation related services—“may create the appearance or risk of a conflict of interest that may call into question the objectivity of the consultants' executive pay recommendations.”

Under the new rules, if a company's compensation consultant or its affiliates provide other services to the company (not involving the amount or form of executive and director compensation) in excess of \$120,000 during a fiscal year, then the company will be required to disclose in its annual report or proxy statement:

- The aggregate fees paid to the compensation consultant for work related to such compensation-related matters;
- The aggregate fees paid to the compensation consultant or any of its affiliates for all other work; and
- If the executive and/or director compensation work was through an engagement with the compensation committee, whether the decision to engage the compensation consultant or its affiliates for non-executive and director compensation services was made, recommended, subject to screening or reviewed by management and whether the board of directors or the compensation committee has approved the non-executive and director compensation services.

Disclosure under the new rules will not be triggered if the compensation consultant's compensation-related services are either limited to broad based plans that do not discriminate in favor of executive officers or directors or are limited to providing information that is not customized for the company or is customized based on parameters that are not fixed by the company.

Board Leadership and Risk Management

Under the new rules, a company will be required to outline its board leadership structure in its annual report or proxy statement and explain why it believes that structure is best for the company. The disclosure must address whether and why a company believes it is appropriate for the roles of chairman and chief executive officer to be combined or separated, and whether the company has a lead independent director. The SEC believes that such disclosure should consider a variety of factors, including the size of the company, the nature of the company's business and the nature and scope of the company's internal control over financial reporting.

The new rules also require a company to include in its annual report or proxy statement a narrative discussion of the role of the board of directors with respect to the company's risk oversight process, particularly with respect to credit risk, liquidity risk and operational risk matters. Under NYSE listing standards, a company's audit committee is responsible for overseeing the company's policies with respect to risk assessment and risk management and discussing with management the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The new rules go beyond the NYSE listing standards and require a company to discuss how the board of directors discharges its responsibilities with respect to risk oversight. At a minimum, this discussion would have to address how the company perceives the role of the board of directors and any committee with risk oversight responsibilities, as well as the relationship between the board and any such committee and senior management in overseeing the material risks associated with the company's operations.

Director Qualifications

The new rules enhance the disclosure requirements of Item 401 of Regulation S-K regarding the qualifications of all directors and director nominees. Currently, Item 401 requires disclosure of five years of business experience and other biographical information for each director and director nominee. The new rules require a company to disclose for each director or nominee for director the specific experience, qualifications, attributes or skills that, in light of the company's business and structure, qualify the individual to serve on the board of directors. The final rules eliminated the proposal that would have required similar disclosure with respect to a board member's service on a committee of the board.

The new narrative disclosure may include, among other things, information about an individual's risk assessment skills, particular area of expertise or past experience, as well as an explanation as to why the individual's service as a director would benefit the company. The expanded disclosure applies to incumbent directors, to nominees for director who are selected by the company's nominating committee and to any shareholder nominees.

In addition, the new rules expand the look-back period for disclosure of prior legal proceedings of an executive officer or director from five to ten years. The new rules also expand the class of legal proceedings subject to disclosure to 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.

The disclosures need not include information concerning the settlement of civil proceedings between private litigants.

In addition, the amendments also require a company to disclose whether and, if so, how, diversity is considered by the board of directors or its nominating committee in evaluating and recommending nominees for election to the board of directors. If the board of directors or nominating committee has a policy with regard to consideration of diversity, the rules require

disclosure of how the policy is implemented, as well as how the board or committee assesses the effectiveness of the policy. The amendments are designed to provide investors with more meaningful disclosure to help them in their voting decisions by better enabling them to determine whether and why a director or nominee is a good fit for a particular company, and to allow companies flexibility in highlighting particular information and specific qualifications of each director and director nominee.

Accelerated Reporting of Results of Shareholder Votes

Under current SEC rules, shareholder vote results are required to be disclosed in the next periodic report on Form 10-Q or 10-K. Under the new rules, a company's obligation to disclose shareholder vote results generally has been accelerated to four business days under new Item 5.07 of Form 8-K. If final results are not known within four business days of the meeting, such as when there is a contested election, then preliminary voting results must first be filed within four business days and an amended Form 8-K must be filed within four business days of the availability of the final results of the shareholder vote.

Compliance

As companies work to evaluate and revise their compensation risk strategies, it is important to remember that there is no one-size-fits-all solution. Every company faces unique challenges based on its industry and specific operations that will require it to analyze its compensation risks in different ways. *For assistance in assessing your company's risk management profile and complying with the new rules, please contact the Seyfarth attorney with whom you work, or any [Corporate](#) or [Employee Benefits](#) attorney on our website.*



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