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Client Alert

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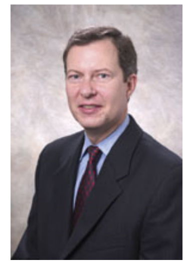
SEC Adopts Final Rules Regarding Compensation and Corporate Governance Disclosures

As we previously reported in our August 6, 2009 *Client Alert*, on July 10, 2009, the SEC published proposed changes to its rules regarding compensation and corporate governance disclosures in proxy statements and, with respect to the reporting of voting results, on Form 8-Ks. On December 16, 2009, the SEC adopted, with certain revisions, these proposed rules. In addition, on January 20, 2010, the SEC issued interpretative guidance regarding these new rules. This Client Alert will summarize the new rules and offer practical guidance on how to comply with these new requirements.

The final compensation rules impose new disclosure obligations with respect to (1) the relationship of a company's compensation policies and practices and risk management, (2) fees paid to compensation consultants, and (3) the aggregate grant date fair value of equity awards. The final corporate governance rules impose new disclosure obligations with respect to (1) the board's role in risk oversight, (2) additional biographical and related information for directors and director nominees, (3) the board's leadership structure and why the board believes the structure is appropriate, (4) the board's considerations of diversity, if any, in the nomination process, and (5) the results of shareholder meetings on Form 8-K instead of Form 10-Q or Form 10-K.

In general, the new rules are applicable to calendar-year-end companies for the upcoming 2010 proxy season. With the exception of the new rules on the relation of the company's compensation policies and practices and risk management, the rules are applicable to smaller reporting companies.



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Compensation Rules

1. Compensation Policies and Risk Management

New Requirements

The new rules require companies to discuss their compensation policies and practices for all employees (not just their "named executive officers") if those policies and practices create risks that are "reasonably likely to have a material adverse effect on the company." The new rules include a nonexclusive list of situations where a company's compensation policies and practices may result in a material adverse effect to the company. The "reasonably likely to have a material adverse effect" disclosure threshold is a high bar for disclosure and represents a significant change from the "may have a material effect" threshold the SEC proposed in July. Another change from the proposed rules is that any disclosure that is required will be made outside of the CD&A, as the SEC agreed with a number of commenters that the CD&A should continue to focus solely on the compensation paid to named executive officers.

Practical Guidance

We believe that companies should immediately assess all of their compensation policies and practices to determine whether any of these policies and practices trigger disclosure under the new rules. In conducting this assessment, companies should keep in mind that (1) mitigating controls should be considered in determining whether the "reasonably likely to have a material adverse effect" standard has been met, (2) the focus of the inquiry should be on the impact to the company as a whole, not just to an individual business unit, and (3) performance-based incentive compensation is the type of compensation most likely to result in such risks.

We expect that many (if not most) companies, after conducting the risk assessment, will conclude that they do not have any compensation policies or practices that must be disclosed. In that case, the company is not required to make an affirmative statement that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company. However, we would recommend that companies (1) carefully document the risk assessment that was undertaken and (2) consider describing the risk assessment and its results in the proxy statement. Such disclosure could be included in the section discussing the board's role in risk oversight (discussed below). Please note that TARP recipients still must comply with the disclosure requirements related to risk and compensation, regardless of whether they are required to make any disclosures under these new SEC rules.

If a company determines as part of the risk assessment that it does have compensation policies or practices that must be disclosed, the company should present the disclosure together with the company's other compensation disclosures. The new rules include examples of issues that the company should consider (among others) in preparing the disclosure. In particular, the company may want to address the factors that the company considered when it adopted the policies in question and how it balanced those factors against the potential risk to the company. The company may also want to take the opportunity to consider whether to continue these policies and practices going forward, in light of the potential risks.

2. Compensation Consultants

New Requirements

Current SEC rules require disclosure of the role of a compensation consultant in determining or recommending the amount or form of executive or director compensation. The new rules expand this requirement to require, in certain circumstances, additional disclosure regarding fees paid to compensation consultants that consult on executive or director compensation. The new rules clarify, however, that providing services involving *only* broad-based nondiscriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant, are not considered executive compensation consulting services that trigger the disclosure obligation, subject to certain limitations.

Under the new rules, no fee disclosure is required in the following situations:

- *No additional services.* The board or compensation committee retains a compensation consultant that consults only on executive and director compensation and provides no additional services to the company. Consulting on broad-based, nondiscriminatory plans and providing information relating to executive or director compensation are not considered "additional services" if such services are in connection with determining or recommending the amount or form of executive or director compensation. However, any related services, such as consulting on benefits administration, human resources services, actuarial services, or merger integration services, would be considered additional services.

- *Immaterial additional services*. The board or compensation committee retains a compensation consultant that consults on executive and director compensation and also provides additional services, but the value of these additional services does not exceed $120,000 during the fiscal year.

- *Separate consultant*. Management retains a compensation consultant to consult on executive and director compensation, but the board or the compensation committee retains its own consultant that does not provide additional services or only provides immaterial additional services.

Fee disclosure is required, however, if the board (or compensation committee) or management engages a compensation consultant that consults on executive and director compensation and provides additional services to the company in excess of $120,000 during the fiscal year. In that case, the following disclosures are required:

- *Aggregate fees*. The aggregate fees paid for consulting on executive or director compensation and the aggregate fees paid for the additional services.

- *Board retained consultant*. If the board or the compensation committee retained the consultant to consult on executive and director compensation, whether the decision to engage the consultant for the additional services was made or recommended by management and whether the board or the compensation committee approved such services.

Practical Guidance

The purpose of the new rules relating to compensation consultants is to provide investors with information regarding the existence of potential conflicts of interest in the compensation-setting process. To avoid potential conflicts of interest, and the related disclosure, compensation committees should consider hiring a compensation consultant that will only advise on executive and director compensation and not provide any additional services. To ensure that appropriate disclosures are included in the proxy statement, companies may want to consider adding a question regarding compensation consultants to their D&O questionnaires, as compensation committees have independent authority to retain compensation consultants and management may not be fully aware of the consulting services provided by compensation consultants.

3. Equity Awards

New Requirements

Current SEC rules require companies to disclose in the Summary Compensation Table and Director Compensation Table the compensation expense they recognized during the applicable fiscal year with respect to equity-based awards granted to their named executive officers. The new rules require companies to instead disclose the aggregate grant date fair value of the equity awards granted to named executive officers during the applicable fiscal year, which the SEC and many commenters believe will better match the tabular disclosure with the decisions made by the compensation committee.

In a change from the proposed rules, the SEC decided not to rescind the requirement (which is not applicable to smaller reporting companies) to report the full grant date fair value of each equity award during the fiscal year in the Grants of Plan-Based Awards Table and the Director Compensation Table. The new rules also provide that the grant date fair value of awards with performance conditions should be based upon the probable outcome of meeting the conditions. The maximum potential value of performance-based awards should also be disclosed in a footnote to the Summary Compensation Table and the Director Compensation Table assuming that all of the conditions would be met.

To facilitate year-to-year comparisons, in the year the company adopts the new rules, the company is required to recompute the amounts previously reported in the stock awards and option awards columns of the Summary Compensation Table to disclose the aggregate grant date fair value of awards made in previous years. The fair value of awards made in previous years should be computed based on the individual grant date fair values previously reported in the Grants of Plan-Based Awards Table for the applicable year, except that performance-based awards should be reported as discussed above. Although the amounts disclosed in the total compensation column for previous years must also be recomputed, companies are not required to include different named executive officers for previous fiscal years based on changes in executive officers' total compensation.

Practical Guidance

The new rules are a welcome change from the current regime and should not be difficult for companies to implement. One consequence of the new rules is that there may be more volatility in executive compensation from year to year if executives receive large grants in one year but not the next (e.g., on hire, when promoted, etc.). This volatility could also result in more frequent changes in the composition of companies' named executive officers. Compensation committees should be mindful of these disclosure obligations when making grants to executive officers.

Corporate Governance Rules

1. Board's Role in Risk Oversight

New Requirements

The new rules require disclosure of the board's role in the oversight of risk. This disclosure is intended to 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. This disclosure requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals.

Practical Guidance

We recommend that boards take this opportunity to closely examine their role in risk oversight to ensure that they are providing active and effective oversight in an area that has captured the attention of legislators, regulators, and the public. If they have not done so already, boards may want to formalize their processes related to risk oversight as a matter of good corporate governance and to facilitate compliance with the newly required disclosure. In addressing these issues, NYSE-listed companies should take care to adhere to NYSE-listing requirements, which require audit committee involvement in the risk-oversight process.

2. Enhanced Disclosures Related to Directors, Director Nominees, and Executive Officers

New Requirements

The new rules require enhanced biographical disclosures regarding the qualifications and business background of directors and director nominees. Companies must now disclose for each director (including those not up for re-election) and director nominee the particular experience, qualifications, attributes, or skills that led the board to conclude that the person should serve as a director. Although companies have flexibility in making this disclosure, the SEC reiterated in the adopting release that companies must disclose all experience, qualifications, attributes, or skills that led the board to conclude that the person should serve as a director. In a change from the proposed rules, the final rules do not require the company to disclose the specific experience, qualifications, or skills that qualify the person to serve as a committee member. However, if a person is chosen to be a director or a director nominee because of particular experience, qualifications, attributes, or skills related to service on a specific committee, then that should be disclosed.

The new rules require disclosure of other public company and registered investment company directorships held by directors and director nominees over the previous five years, not just those held at the time of filing as required by the current rules. The new rules also amend the legal proceedings disclosures for directors, director nominees, and executive officers, expanding the types of proceedings that must be disclosed and increasing the "look-back" from five to ten years.

Practical Guidance

The starting point for gathering the required disclosures will likely be the company's annual D&O questionnaire, which should be revised to address the new requirements. For the enhanced disclosure regarding director and director nominee qualifications, boards may want to consider an iterative process whereby each director and director nominee works with the company and counsel to prepare an enhanced biographical sketch. Once prepared, the new sketches for each of the directors and director nominees should be reviewed and discussed by the nominating committee as part of the annual director nomination process. Companies should start this process early to allow sufficient time to flesh out the appropriate disclosures.

With respect to the presentation of the disclosure, companies should be mindful that investors (particularly activist investors) will expect to see this enhanced disclosure. In its January 20, 2010 guidance, the SEC reiterated that these disclosures must be particularized for each individual director; companies may not make these disclosures on a group basis. For specific skills and qualifications, companies may want to explain how the individual acquired that skill (e.g., former CEO, board experience, etc.). In addition, even if certain experience, qualifications, or skills did not cause the board to conclude that a person was qualified to serve on a committee, companies may want to make such disclosure as a best practice.

3. Board's Leadership Structure

New Requirements

The new rules require companies to disclose their board leadership structure and the reasons for that structure. In particular, a company must 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 its board leadership structure is the most appropriate structure for the company. If a company combines the role of CEO and board chair but has a lead independent director, the company must 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.

Practical Guidance

The SEC stated that the purpose of these amendments is to provide investors with more transparency about the company's corporate governance and not to influence a company's decision regarding its board leadership structure. That said, given the current environment, companies that do not separate the CEO and the chair or do not have a strong lead independent director will need to carefully articulate the reasons for such a leadership structure. Boards should also be mindful that RiskMetrics will generally recommend a vote for shareholder proposals requiring the board chair to be filled by an independent director, unless the company maintains a specified counterbalancing governance structure, including, among other things, having a designated lead director with clearly delineated and comprehensive duties, elected by and from the independent board members.

4. Board's Considerations of Diversity

New Requirements

The new rules require companies to disclose whether, and if so how, the nominating committee (or the board) considers diversity in identifying director nominees. In addition, if the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, the company must disclose how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy. The SEC agreed with commenters that this disclosure may provide investors with important information on corporate culture and governance practices. The SEC acknowledged that companies may define diversity in various ways, reflecting different perspectives. For instance, some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skills, and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender, and national origin. Consequently, for purposes of the disclosure requirement, companies are allowed to define diversity in ways that they consider appropriate.

Practical Guidance

The new requirements will force companies, as part of the annual board nomination process, to formally focus on diversity, whereas in the past many boards have only done so informally. We recommend that companies amend their D&O questionnaires to elicit information from each director and director nominee regarding any specific characteristics, viewpoints, or attributes possessed by the director or director nominee that he or she believes may increase the diversity of the company's board. Nominating committees and boards should then consider this information when identifying director nominees. Nominating committees and boards may also want to adopt new diversity policies or revise existing ones.

As part of this process, boards may decide that they would benefit from greater diversity. Boards that are interested in identifying candidates who may contribute to board diversity may consider contacting the Director Diversity Initiative at the University of North Carolina School of Law or the local chapter of the National Association of Corporate Directors.

5. Accelerated Reporting of Shareholder Voting Results on Form 8-K

New Requirements

The new rules amend Form 8-K to add a new Item 5.07 that requires disclosure of the results of any shareholder vote within four business days after the date of the meeting at which the vote was held. If definitive vote results are not available within four business days, companies are required to disclose preliminary results within four business days and amend the Form 8-K within four business days of the certification of the final results. Corresponding disclosure is required for matters that are submitted to a shareholder vote otherwise than at a meeting. As a result of the new rules, vote total disclosure will no longer be required in Form 10-Qs and Form 10-Ks, which are often filed months after a meeting is held.

Practical Guidance

Companies will need to revisit their disclosure controls and procedures to ensure that they are equipped to report voting results within four business days. A critical part of this process will be working with the independent tabulator and inspector of elections so that they understand the timing and can provide the company preliminary (and preferably final) results immediately following the meeting.

Conclusion

These new rules will elicit sensitive disclosure that goes to the heart of the composition, role, and functioning of public company boards. Given the relatively short timeframe for companies to comply with the new rules, it is important that companies that have not already done so carefully consider the scope of the additional disclosures that will be required this proxy season and the actions that boards and management will need to take to satisfy these new requirements.

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While every effort has been made to ensure the accuracy of this memorandum, it is not intended to provide legal advice as individual situations will differ and should be discussed with an expert and/or lawyer. For specific technical or legal advice on the information provided and related topics, please contact Gerald Roach at 919.821.6668, Amy Batten at 919.821.6677, or Margaret Rosenfeld at 919.821.6714.

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