ZAG/S&W LLP CORPORATE ADVISORY

SEC Mandates Increased Disclosures Regarding Executive Compensation, Risk, Director Qualifications and Corporate Governance

With proxy season looming, companies learned that the process will be even more onerous in 2010 after the Securities and Exchange Commission approved rules that will require additional disclosures about executive compensation and corporate governance. Companies will now be required to disclose the board's role in risk oversight, as well as how employee pay might encourage risky behavior. The amendments also include enhanced transparency regarding the qualifications of directors and nominees, disclosures about whether and how diversity is considered in the director nomination process, disclosures regarding potential conflicts of interests of compensation consultants, and a modification to the way stock and option awards are valued. The new rules will further result in quicker reporting of shareholder voting results.

COMPENSATION POLICIES AND PRACTICES AND THEIR RELATION TO RISK MANAGEMENT

Responding to claims that compensation policies have given employees incentives to deliver short-term profits at the expense of generating systemic risks, the new SEC rule requires a company to discuss its compensation polices and practices for employees to the extent the risks arising from such policies and practices are "reasonably likely" to have a material adverse effect on the company.

This rule is a departure from the SEC's former approach in that it applies not only to named executive officers, whose compensation is already required to be discussed and analyzed in compensation discussion and analysis, or CD&A, but to all employees, including non-executive officers. However, to the extent a company's compensation policies are not reasonably likely to have a material adverse effect, the new rule requires no disclosures.

To provide guidance to corporate issuers, the final rule offers a non-exhaustive list of situations that might potentially trigger discussion, including compensation policies at a business unit that carries a significant portion of the company's risk, or policies that award bonuses when a task is accomplished, while the income and risk to the company from the task extend over a significantly longer period of time.

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If a company determines disclosure is required by the new rule, the amendments also provide examples of issues that may need to be addressed, including:

- The general philosophy of the company's compensation policies for employees whose behavior would be most affected by the created incentives, as such policies relate to risk-taking;
- The company's risk assessment in structuring its compensation policies;
- How the company's compensation practices relate to short- and long-term risks, such as policies requiring claw backs or imposing holding periods;
- Policies regarding adjustments to compensation practices to address changes in risk (including material adjustments actually made); and
- Monitoring efforts to determine whether compensation practices are helping the company to meet risk-management goals.

Instead of requiring this discussion to be included in CD&A, as initially proposed by the SEC, the rule does not provide guidance about where the discussion should appear in proxies and information statements; however, CD&A should contain similar information regarding named executive officers, to the extent material.

Like CD&A, this requirement does not apply to smaller reporting companies. According to the SEC, such companies are less likely to employ the types of compensation practices that the amended rule is intended to address.

INCREASED DISCLOSURES ABOUT DIRECTORS AND NOMINEES

The new rules require public companies to disclose the particular experience, qualifications or skills of directors and nominees that led to the conclusion that the person should serve as a director, in light of the company's business and structure.

The amendments do not specify particular information that must be disclosed, affording companies flexibility in determining which abilities and qualifications will be relevant to investors. However, any identifiable skills that were material to the selection process should be mentioned in the discussion. This information must be provided for all continuing directors, whether or not up for re-election.

The SEC expanded the scope of the rule requiring disclosure of other directorships held by each director. Companies will now have to disclose service by directors or nominees on the boards of any public company or registered investment fund during the previous five years.

Also expanded by the amended rule is the list of legal proceedings for which disclosure is required. Mandatory disclosure now covers proceedings involving fraud, violations of securities, commodities, banking or insurance laws, and any disciplinary sanctions imposed by a stock exchange or other self-regulatory institution. In addition, the period during which disclosure of legal proceedings is required will now stem back ten years, up from five under the previous rules.

The enhanced director and nominee disclosures will also apply to candidates for director nominated by shareholders.

CONSIDERATION OF DIVERSITY IN THE DIRECTOR NOMINATION PROCESS

Marking a surprise addition to the proposed rules, the final amendments will require companies to disclose whether diversity is considered by the nominating committee when identifying and selecting candidates for director. If a company's nominating committee has a policy with regard to the consideration of diversity, the company will now be required to disclose the methods of implementation and how the committee assesses the policy's effectiveness.

The new rules do not define "diversity," so companies are free to use any definition they consider appropriate. For example, some companies might define diversity according to the viewpoint or background of a candidate that contributes to board heterogeneity, whereas others may focus on concepts such as race, gender or national origin.

BOARD LEADERSHIP STRUCTURE AND ITS ROLE IN RISK OVERSIGHT

The new rules require companies to disclose whether they have separate principal executive officers and board chairpersons, or whether such positions have been combined. Reporting companies must also discuss their reasons for believing the current structure is appropriate given the specific characteristics or circumstances of the

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company. Though merely a disclosure rule, companies have been under pressure by shareholder advisory firms such as RiskMetrics Group, as well as pending legislation, to separate the CEO and chair roles.

For companies in which the role of CEO and board chairman are combined, the amended rules additionally require disclosure of whether and why the company has a lead independent director, as well as that director's specific role in board leadership.

Potentially more burdensome is the new requirement that companies provide investors with information about how they perceive the relationship between the board and senior management in managing material risks. Proxy statements must now describe the board's role in risk oversight, either as a whole or through committees, and the effect this has on the board's leadership structure.

REVISIONS TO THE SUMMARY COMPENSATION TABLE

The new rules also change a formula that was criticized as allowing companies to understate executives' equity compensation, which often makes up a substantial portion of top executives' pay. In response, the SEC revised the manner in which stock and option awards are reported in the Summary Compensation Table and the Director Compensation Table.

The amended rule requires companies to report the aggregate grant date fair value of equity awards when they are granted, departing from the former approach under which the amounts expensed for all awards during the fiscal year were reported. As a result of the change, the total compensation for some executives may appear to spike in certain years. To avoid investor confusion, companies should consider providing an explanation of the rule change in the narrative section of the proxy statement.

For performance-based awards, the compensation table will state the value of the equity grant, based on the probable outcome of the performance conditions as of the grant date. The disclosure must also include a footnote stating the award's potential maximum value assuming the highest level of performance, which will allow investors to understand the award's upper limit without requiring its tabular disclosure.

This rule, which applies to companies with fiscal years ending on or after December 20, 2009, requires recomputed disclosures for the two preceding fiscal years under the new approach. To lessen the burden of transitioning, the SEC will not require companies to update named executive officers for any preceding fiscal year based on recomputing total compensation for those years.

COMPENSATION CONSULTANTS AND CONFLICTS OF INTERESTS

Companies regularly retain consultants to make recommendations on executive and director compensation, to design incentive plans and provide information on market-standard pay practices. However, many compensation consultants generate fees from additional work, which shareholders have argued could create conflicts that undermine the objectivity of the consultant's advice on executive compensation.

Under prior rules, companies were required only to describe the compensation consultant's role in recommending executive and director pay. Responding to growing concerns over conflicts of interest, the new rule requires disclosure of fees paid to consultants that provide other non-compensation consulting services which generated aggregate fees in excess of $120,000 during the fiscal year. Under those circumstances, companies must also disclose whether the decision to engage the compensation consultant for non-compensation services was made or recommended by management, and whether the board approved the other services.

The additional disclosures do not apply if the board and management engage different consultants, even if management's consultant provides additional services. Also exempt are services relating to certain broad-based plans and providing non-customized information.

SHAREHOLDER VOTING RESULTS

In order to provide the public with more up-to-date information, the SEC will now require companies to report shareholder voting results on Form 8-K, which must be filed within four business days after a meeting's end. Accordingly, shareholder voting results will no longer be required to be reported on Forms 10-Q and 10-K.

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If a company's definitive voting results cannot be determined within four business days of the meeting, it must file the preliminary voting results on Form 8-K; once the final results are known, the company must file an amended report within four business days.

EFFECTIVE DATES AND TRANSITION

The new rules regarding executive and director compensation are effective for proxy statements and registration statements filed after February 28, 2010 that are required to include the relevant information for fiscal years ending after December 20, 2009. For example, for a company that operates under a calendar fiscal year end, a proxy statement for the 2010 annual meeting of shareholders filed after February 28, 2010 will need to contain all of the enhanced corporate governance, compensation and risk-management disclosures for the year ended December 31, 2009. Preliminary proxy statements filed before February 28 must also contain the new disclosures if the definitive proxy statement is expected to be filed after February 28.

WHAT THIS MEANS FOR PUBLIC COMPANIES

Although the new rules are not as far-reaching or cumbersome as the SEC's 2006 executive compensation reforms and don't mandate any disclosure necessarily as a "best practice", companies will need to engage in additional analyses and planning before upcoming proxy statements to make sure they understand the compensation, risk and governance practices and structures they have in place and to determine if any changes should be considered. While the amended rules afford some flexibility in the specifics to be discussed, companies should plan well in advance how they intend to formulate new disclosures, as there will be little precedent in previous filings. In particular:

- Disclosure controls and procedures will need to be adjusted to take into account all of the new disclosures and any potential issues need to be identified early in the process to avoid surprises;
- Director and officer questionnaires will need to be updated to elicit additional information required by the new rules, such as other board memberships over the last five years, additional legal proceedings over the last ten years and additional qualifications;
- Companies will need to inventory all of their employee compensation arrangements, plans and programs that have an impact on, or can create, risk, in order to analyze whether any such policies are reasonably likely to have a material adverse effect on the company; companies should also consider whether any policies to mitigate risk are appropriate, such as claw back policies or stock retention guidelines; boards and compensation committees should be involved with these conclusions and decisions;
- Companies should determine whether any compensation consultants are engaged for other services and the process for retention of consultants; companies should further consider whether use of the same firm for multiple services and engagement of consultants by management rather than the compensation committee creates potential conflicts of interest;
- Boards should consider whether they want to adopt new or revised policies regarding risk-oversight procedures and ensure that they work as expected;
- Boards should consider their leadership structures and determine why they believe the structures they have adopted are appropriate, or whether changes are needed, anticipating that shareholders are likely to carefully review the company's rationale;
- If a board has or adopts a policy on diversity, it should consider how it will implement and assess the effectiveness of such policy, as well as what it considers as an appropriate definition of diversity for these purposes;
- Boards should ensure they have clearly articulable rationales for why their directors are qualified to serve on the board; and
- To lessen perceived spikes in executive compensation that may result from the new Summary Compensation Table formula, companies may consider changing the structure of equity program features that impact grant date fair values.

The summary above is meant to describe the major changes required under the SEC's new proxy disclosure enhancements. To discuss these topics in more detail, please contact your lawyer at Sullivan & Worcester LLP or one of the lawyers listed above.

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