

Executive Compensation & Employee Benefits | December 18, 2009

## SEC's New Year's Resolution Requires Companies to Enhance Compensation and Governance Disclosure

Only weeks before the ball is set to drop in Times Square, the U.S. Securities and Exchange Commission (the "**Commission**") announced that it will be ringing in the New Year by amending the proxy disclosure rules to enhance the disclosure registrants are required to make about compensation and other corporate governance matters.

### Introduction

At its open meeting on December 16, 2009, the Commission voted 4-to-1 to adopt final rules that amend the proxy disclosure rules applicable to all U.S. publicly listed registrants (the "**Final Rules**").<sup>1</sup> The Final Rules are intended to "improve corporate disclosure regarding risk, compensation and corporate governance matters when voting decisions are made" so that shareholders "are better able to evaluate the leadership of public companies."<sup>2</sup> Although the Final Rules are similar to the proposed amendments that the Commission issued in July (the "**Proposed Rules**"),<sup>3</sup> there are several key differences that the Commission introduced in response to the more than 130 comment letters it received on the proposal. The chart below summarizes the material differences between the Proposed Rules and the Final Rules, as well as how each differ from the current disclosure requirements. The amendments will become effective on February 28, 2010.

<sup>1</sup> Securities and Exchange Commission Release Nos. 33-9089; 34-61175 (Dec. 16, 2009).

<sup>2</sup> Press Release No. 2009-268, U.S. Securities and Exchange Commission (Dec. 16, 2009).

<sup>3</sup> Securities and Exchange Commission Release No. 33-9052 (July 10, 2009). For an in-depth discussion of the Proposed Rules, you may refer to the Shearman & Sterling LLP Client Publication titled *Executive Compensation and Governance-Related Reforms Propose Extensive Changes to Procedure and Disclosure* (July 27, 2009), available at <http://www.shearman.com/executive-compensation-and-governance-related-reforms-propose-extensive-changes-to-procedure-and-disclosure/>.

Topic	Current Rule	Proposed Rule	Final Rule
<p>Disclosure Regarding Relationship of Compensation Policies to Risk</p>	<ul style="list-style-type: none"> <li>Pursuant to Item 402 of Regulation S-K, the Compensation Discussion and Analysis (the "<i>CD&amp;A</i>") must contain a narrative discussion that provides an overview of a registrant's compensation program for its named executive officers ("<i>NEOs</i>") and an analysis of the material elements of the registrant's compensation for the <i>NEOs</i>.</li> </ul>	<ul style="list-style-type: none"> <li>The <i>CD&amp;A</i> would be broadened to include a new section requiring disclosure of the registrant's overall compensation policies for all employees, not just <i>NEOs</i>, if the risks arising from those policies "may have a material effect" on the registrant.</li> <li>Examples of situations that could trigger this additional disclosure requirement include practices at a business unit: <ul style="list-style-type: none"> <li>that carries a significant portion of the registrant's risk profile;</li> <li>with compensation structured significantly differently than other units within the registrant;</li> <li>that is significantly more profitable than other units;</li> <li>where compensation expense is a significant percentage of the unit's revenues; or</li> <li>that vary significantly from the overall risk and reward structure of the registrant (<i>e.g.</i>, where bonuses are awarded upon accomplishment of a task while the risk to the registrant from that task extends over a significantly longer period of time).</li> </ul> </li> <li>The types of disclosure must be determined on a case-by-case basis, but may include: <ul style="list-style-type: none"> <li>the general design philosophy of compensation policies for employees whose behavior would be most influenced by the incentive programs;</li> <li>the registrant's risk assessment or considerations in structuring its incentive compensation policies;</li> <li>the ways in which the registrant's compensation policies relate to the realization of risks resulting from the actions of employees (<i>e.g.</i>, through the use of clawbacks or holding periods);</li> <li>the registrant's policies regarding adjustments to its compensation practices to address changes in its risk profile;</li> <li>material adjustments the registrant has made to its compensation policies or practices as a result of changes in its risk profile; and</li> <li>the extent to which the registrant monitors its compensation policies to determine whether risk management objectives are being met.</li> </ul> </li> <li>The Commission sought comment on whether a registrant should be required to affirmatively state in its <i>CD&amp;A</i> that it has determined the risks arising from its broader compensation policies are not reasonably expected to have a material effect on the registrant.</li> </ul>	<ul style="list-style-type: none"> <li>The Final Rules adopt the disclosure requirement substantially as set forth in the Proposed Rules, with the following exceptions: <ul style="list-style-type: none"> <li>Registrants must discuss their compensation policies and practices for all employees if they create risks that "are <i>reasonably likely</i> to have a material adverse effect" on the registrant, as opposed to those that "<i>may</i> have a material effect."</li> <li>These new disclosure requirements will not be a part of the <i>CD&amp;A</i> as proposed. Instead, the risk discussion will be set forth in its own section of the proxy statement.</li> </ul> </li> <li>The Final Rules include, as proposed, the illustrative examples of (i) circumstances that could trigger the additional disclosure requirement and (ii) issues that potentially would be appropriate for a registrant to address if the requirement was triggered.</li> <li>After seeking comments, the Commission decided <i>not</i> to require a registrant to make an affirmative statement that it has determined the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the registrant.</li> </ul>

Topic	Current Rule	Proposed Rule	Final Rule
Reporting of Stock Options and Other Equity Awards	<ul style="list-style-type: none"> <li>For stock options and other equity awards, Item 402 of Regulation S-K currently requires disclosure in the Summary Compensation Table and Director Compensation Table of the dollar amount recognized by the registrant for financial statement reporting purposes for the fiscal year.</li> </ul>	<ul style="list-style-type: none"> <li>Registrants would be required to disclose the full grant date fair value of awards in the year of grant, calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation – Stock Compensation (“<i>FASB ASC Topic 718</i>”).<sup>4</sup></li> <li>The Proposed Rules 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.</li> <li>The Proposed Rules would also amend the instructions to the “Salary” and “Bonus” columns of the Summary Compensation Table so that registrants would not be required to report the amount of salary or bonus forgone at an NEO’s election, and the non-cash awards received in lieu of salary or bonus would be reported in the column applicable to the form of award elected by the NEO.</li> </ul>	<ul style="list-style-type: none"> <li>The Final Rules are similar to the Proposed Rules, but add an instruction for awards subject to corporate performance conditions, such as conditions related to earnings or other internal metrics. (Market conditions, such as the attainment of a specified stock price or level of shareholder return, already are reflected in the grant date fair value calculation and, therefore, are not subject to this rule.) <ul style="list-style-type: none"> <li>The value of performance awards reported in the Summary Compensation Table and Director Compensation Table must be computed based on the probable outcome of the performance conditions as of the grant date.</li> <li>The maximum potential value of the award must be disclosed in a footnote to the Summary Compensation Table or Director Compensation Table.</li> <li>Like the Proposed Rules, the Final Rules require disclosure of the aggregate grant date fair value of equity awards <i>granted during</i> the relevant fiscal year and not the value of equity awards granted <i>for services</i> in the relevant fiscal year.</li> </ul> </li> <li>The Commission retained the requirement to report the full grant date fair value of each equity award in the Grants of Plan-Based Awards Table and the Director Compensation Table.</li> <li>The Commission decided not to adopt the amendment to the instructions to the “Salary” and “Bonus” columns of the Summary Compensation Table. Consequently, registrants will continue to be required to report in those columns the amount of salary or bonus forgone at an NEO’s election.</li> <li>Registrants providing Item 402 disclosure for a fiscal year ending on or after December 20, 2009 must recompute the disclosure in the Summary Compensation Table for each preceding fiscal year shown in the table as if the Final Rules were then in effect. <ul style="list-style-type: none"> <li>The “Total Compensation” column must be recomputed.</li> <li>If a person who was an NEO for the most recent fiscal year was also disclosed as an NEO for 2007, but not for 2008, the NEO’s compensation for each of those three fiscal years must be disclosed.</li> </ul> </li> </ul>

<sup>4</sup> Both the Proposed Rules and the former disclosure requirements referred to Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment (“*FAS 123R*”). In the Final Rules, the Commission updated references to FAS 123R to reflect that the FASB Accounting Standard Codification has superseded all references to previous FASB standards for interim or annual periods ending on or after September 15, 2009.

Topic	Current Rule	Proposed Rule	Final Rule
<p><b>Director and Nominee Disclosure</b></p>	<ul style="list-style-type: none"> <li>• <b>Qualifications:</b> Item 401 of Regulation S-K currently requires registrants to provide (i) relatively brief biographical information about directors and director nominees for the past five years and (ii) a general disclosure about the registrant's director qualification requirements.</li> <li>• <b>Other Directorships:</b> Registrants must disclose any directorships at other public registrants currently held by each director or director nominee.</li> <li>• <b>Legal Proceedings:</b> Registrants must disclose certain legal proceedings (which generally include bankruptcy proceedings, criminal proceedings and material violations of securities laws) involving its directors, director nominees and executive officers occurring within the last five years.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Qualifications:</b> The disclosure required for each director or nominee would be expanded to include the specific experience, qualifications or skills that qualify that person to serve as a director or committee member of the registrant. The types of information that may be disclosed include (i) information about the director's/nominee's risk assessment skills, (ii) specific past experience that would be useful to the registrant, (iii) information about the director's/nominee's particular area of expertise, and (iv) reasons why the director's/nominee's service would benefit the registrant.</li> <li>• <b>Other Directorships:</b> Registrants would be required to disclose any directorships at other public registrants held by the director or director nominee within the last five years, even if the director or nominee no longer holds that position at the time of the relevant filing.</li> <li>• <b>Legal Proceedings:</b> The period of time during which the disclosure of certain legal proceedings is required would be lengthened from five to ten years.</li> </ul>	<ul style="list-style-type: none"> <li>• However, registrants are not required to include <i>different</i> NEOs for any preceding fiscal year based on the recomputed Total Compensation.</li> <li>• <b>Qualifications:</b> The Final Rules require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a member of the registrant's board of directors, <i>but not as a committee member</i>. Also, they do not specify the particular information that should be disclosed. In particular, the Final Rules delete the proposed reference to "risk assessment skills."</li> <li>• <b>Other Directorships:</b> As proposed.</li> <li>• <b>Legal Proceedings:</b> In addition to lengthening the period of time during which disclosure of legal proceedings is required from five to ten years, the Final Rules also expand the list of legal proceedings that must be disclosed to include: <ul style="list-style-type: none"> <li>• Any judicial or administrative proceedings resulting from involvement in mail or wire fraud or other business fraud;</li> <li>• Any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement of those actions (other than settlement of a civil proceeding among private parties); and</li> <li>• Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.</li> </ul> </li> <li>• The Final Rules clarify that the additional disclosure obligations apply to all of the registrant's directors, even if the director is not up for reelection at the time of the filing.</li> </ul>
<p><b>Disclosure about Diversity in the Director Nomination Process</b></p>	<ul style="list-style-type: none"> <li>• Currently, there is no requirement to disclose whether or how a nominating committee considers diversity when nominating directors.</li> </ul>	<ul style="list-style-type: none"> <li>• The Proposed Rules did not require any disclosure regarding diversity in the director nomination process, but the Commission requested comments on whether this disclosure should be required.</li> </ul>	<ul style="list-style-type: none"> <li>• The Final Rules amend Item 407 of Regulation S-K to require disclosure of whether and, if so, how, a registrant's nominating committee considers diversity in identifying director nominees.</li> <li>• If the nominating committee has a diversity policy, the registrant must disclose how the policy is implemented and how the committee (or the board) assesses the effectiveness of the policy.</li> <li>• The Final Rules do not define diversity.</li> </ul>

Topic	Current Rule	Proposed Rule	Final Rule
Disclosure about Leadership Structure	<ul style="list-style-type: none"> <li>Currently, there is no express requirement for a registrant to discuss its leadership structure.</li> </ul>	<ul style="list-style-type: none"> <li>Registrants would be required to disclose their leadership structure and the reasons they believe that particular structure is appropriate.</li> <li>Registrants would also be required to disclose whether and why they chose to combine the principal executive officer and board chair positions.               <ul style="list-style-type: none"> <li>Registrants that have combined the roles of principal executive officer and board chairman would be required to disclose whether and why they have a lead independent director and the specific role that the lead independent director plays in the leadership of the registrant.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>The Final Rules generally adopt the approach taken by the Proposed Rules with respect to disclosure of leadership structure, but use the phrase "board leadership structure" instead of "company leadership structure" to avoid potential confusion that the Final Rules would require a discussion of the structure of management leadership.</li> </ul>
Disclosure about Board's Role in Risk Management	<ul style="list-style-type: none"> <li>Currently, there is no express requirement for a registrant to discuss the role its board of directors plays in the risk management process.</li> </ul>	<ul style="list-style-type: none"> <li>Registrants would be required to disclose the board's involvement in the registrant's risk management process. Issues to be addressed by the registrant may include: (i) the way in which the registrant perceives the role of its board in managing risk, (ii) the relationship between the board and the registrant's senior management in managing risk, (iii) the way in which the board implements and manages its risk management function (<i>i.e.</i>, through the board as a whole or through a committee), (iv) whether those responsible for overseeing risk management report directly to the board as a whole or to a committee, and (v) whether and how the board (or committee) monitors risk.</li> </ul>	<ul style="list-style-type: none"> <li>The Final Rules generally adopt the changes set forth in the Proposed Rules, but use the phrase "<i>risk oversight</i>" instead of "<i>risk management</i>" to more accurately describe the board's responsibility.</li> </ul>
Disclosure Regarding Compensation Consultants	<ul style="list-style-type: none"> <li>Item 407 of Regulation S-K currently requires registrants to (i) identify any compensation consultants who played a role in determining or recommending the amount or form of compensation for directors or executives, (ii) describe the role the consultants played, (iii) state whether the consultants are engaged directly by the compensation committee or any other person, (iv) describe the nature and scope of the consultants' assignment, and (v) discuss the material elements of the instructions</li> </ul>	<ul style="list-style-type: none"> <li>The registrant would be required to provide additional information if the compensation consultant that was involved in determining or recommending the amount or form of executive or director compensation also provided non-executive services to the registrant (unless the consultant's only involvement in executive or director compensation was under a broad-based plan that does not discriminate in favor of the registrant's executives or directors). Specifically, a registrant receiving both executive and non-executive compensation services would be required to disclose:               <ul style="list-style-type: none"> <li>the nature of all non-executive services provided to the registrant by the compensation consultant during the last fiscal year;</li> <li>the aggregate fees paid for all additional services and for work related to determining or recommending the amount or form of executive and director compensation;</li> <li>whether the decision to retain the compensation consultant for non-executive services was made or approved by management; and</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Under the Final Rules, if (i) <i>the board (or a committee thereof) has engaged its own compensation consultant</i> to provide advice on the amount or form of executive or director compensation, (ii) the board's consultant provides other non-executive services to the registrant, and (iii) the fees for the non-executive services performed by the board's consultant exceed \$120,000 during the registrant's fiscal year, then the registrant must disclose <b>both</b> the aggregate fees paid for services with regard to the amount or form of executive and director compensation and the aggregate fees paid for any non-executive compensation consulting services.               <ul style="list-style-type: none"> <li>The registrant must also disclose whether the decision to engage the consultant for non-executive services was made or recommended by management, and whether the board approved the non-executive services.</li> </ul> </li> <li>If the <i>board has not engaged its own consultant</i>, fee disclosure is required if a consultant provides both executive and non-executive services to the registrant and the fees for the non-executive services exceed \$120,000 during the registrant's fiscal year.</li> </ul>

Topic	Current Rule	Proposed Rule	Final Rule
	<p>given to the consultants with respect to the performance of their duties under the engagement.</p>	<ul style="list-style-type: none"> <li>whether the registrant's board or compensation committee approved the non-executive services in addition to the executive compensation services.</li> </ul>	<ul style="list-style-type: none"> <li>Fee and related disclosure for compensation consultants that work with management is not required if the board has retained its own consultant, even if management's consultant provides both executive and non-executive services or participates in board meetings.</li> <li>In addition to adopting the exception from the Proposed Rules for services related only to broad-based plans, under the Final Rules the fee and related disclosure is not required if the services involve only the provision of information, such as surveys, that are not customized for the registrant, or are customized based on parameters that are not developed by the consultant.</li> <li>The Final Rules do not require disclosure of the nature and extent of the additional services provided by the compensation consultant.</li> </ul>
<p><b>Reporting the Results of Shareholder Votes</b></p>	<ul style="list-style-type: none"> <li>Currently, registrants are required to disclose the results of any matter that was submitted to a vote of shareholders either on a Form 10-Q (if submitted during the first, second, or third fiscal quarter) or Form 10-K (if submitted during the fourth fiscal quarter).</li> </ul>	<ul style="list-style-type: none"> <li>Registrants would be required to disclose the results of a shareholder vote on Form 8-K within four business days after the end of the meeting at which the vote was held.</li> <li>If the matter voted upon relates to a contested election of directors and the voting results are not definitely determined at the end of the meeting, registrants would be required to disclose the preliminary voting results on Form 8-K within the four business days and later file an amended report on Form 8-K within four business days after the final voting results are certified.</li> </ul>	<ul style="list-style-type: none"> <li>The Final Rules generally adopt the approach taken by the Proposed Rules with respect to reporting the results of shareholder votes, but expand the instruction to new Item 5.07 of Form 8-K so that registrants will be required to report the preliminary results of voting on any matter (not just contested elections) within four business days after the shareholders' meeting and then file an amended report on Form 8-K within four business days after the final voting results are known.</li> </ul>

## Conclusion

The Final Rules provide that the amendments will become effective on February 28, 2010, but do not clarify how this effective date will be implemented. It appears that registrants filing definitive proxy statements on or after that date will be required to comply with the new disclosure requirements. Given the proximity to the commencement of the 2010 proxy season, the SEC is expected to clarify this issue shortly.

Registrants filing their definitive proxy statements before February 28, 2010 will not have to comply with the Final Rules. While registrants in this situation may consider *voluntary* compliance with some of the new requirements that *supplement* the current rules (for example, risk disclosure and enhanced disclosure about directors), to the extent that the new requirements *replace* existing rules – notably with respect to reporting of equity awards – registrants are required to use the current rules for proxy statements filed before February 28, 2010.

The Proposed Rules solicited comments on whether the Commission should consider a number of additional initiatives aimed at improving executive compensation disclosure, including further revising the way in which stock and option awards are disclosed, requiring disclosure of each executive officer's compensation (not just NEOs), and making the CD&A part of the Compensation Committee Report. The Commission's desire to adopt the Final Rules in time for the 2010 proxy season prevented it from adopting any of these additional changes to executive compensation disclosure. The Final Rules, however, make it clear that the Commission will continue considering these and other initiatives regarding compensation disclosure, leaving open the possibility of additional rulemaking in the future.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Linda E. Rappaport  
New York  
+1.212.848.7004  
lrappaport@shearman.com

John J. Cannon III  
New York  
+1.212.848.8159  
jcannon@shearman.com

Jeffrey P. Crandall  
New York  
+1.212.848.7540  
jcrandall@shearman.com

Kenneth J. Laverriere  
New York  
+1.212.848.8172  
klaverriere@shearman.com

Doreen E. Lilienfeld  
New York  
+1.212.848.7171  
dlilienfeld@shearman.com