

# Client Alert

Corporate Department

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## **SEC Approves Rules Requiring Enhanced Disclosure About Risk, Compensation and Corporate Governance**

### *Enhancements Effective for 2010 Annual Reporting and Proxy Season*

On December 16, 2009, the U.S. Securities and Exchange Commission (the “SEC”) approved final amendments to the rules and regulations relating to proxy statements and other reports filed with the SEC. The amendments will require new or revised disclosures about company compensation policies, executive compensation, director and nominee qualifications and legal proceedings, board leadership policy and structure, the board’s role in risk oversight, board diversity, and fees paid to compensation consultants who provide additional services to the company. In addition, the new rules have accelerated the deadline by which companies must report shareholder voting results. These enhanced disclosure obligations become effective on February 28, 2010. This Client Alert summarizes the additional disclosure that will generally be required for the 2010 annual reporting and proxy season.

### ***Compensation Policies and Practices***

The new rules amend Item 402 of Regulation S-K by requiring companies (except for smaller reporting companies) to discuss and analyze their compensation policies and practices as they relate to risk management practices and risk-taking incentives for all employees, not just “named executive officers”, *but only if* risks arising from those compensation policies or practices are *reasonably likely* to have a *material adverse effect* on the company.<sup>1</sup> The new disclosure is to be discussed separately from the “Compensation Discussion and Analysis” section of the company’s Forms 10-K or proxy or information statements. Companies would likely need to consider and discuss the level of risk that employees might be encouraged to take to receive incentive compensation.

The SEC noted that the following non-exclusive situations could trigger such discussion and analysis under the amended rules.

- Compensation policies and practices at business units:
  - that carry a significant portion of the company’s risk profile;
  - with compensation structured significantly differently than other units within the company;

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<sup>1</sup> This “reasonably likely” disclosure threshold parallels the disclosure threshold used by the SEC in the Management Discussion and Analysis rules, which require risk-oriented disclosure of known trends and uncertainties that are material to the business.

- that are significantly more profitable than others within the company; or
- where the compensation expense is a significant percentage of the unit's revenues.
- Compensation policies and practices that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

The SEC also noted that under the new rules, companies need to discuss issues such as the following regarding the compensation policies or practices that may give rise to the material risk:

- The general design philosophy of the company's compensation policies for employees whose behavior would be most affected by the incentives established by the policies and the manner of its implementation;
- The company's risk assessment or incentive considerations in structuring its compensation policies or in awarding and paying compensation;
- How the company's compensation policies relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw-backs or imposing holding periods;
- The company's policies regarding adjustments to its compensation policies to address changes in its risk profile;
- Material adjustments the company has made to its compensation policies or practices as a result of changes in its risk profile; and
- The extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

Companies will not be required to affirmatively state that they have determined that risks associated with their compensation policies or practices are not reasonably likely to have a material adverse effect.

### ***Summary Compensation Table***

The new rules amend Item 402 of Regulation S-K, requiring the company to disclose in its Forms 10-K, registration statements or proxy or information statements, as applicable, the aggregate grant date fair value of stock and option awards computed in accordance with generally accepted accounting principles in the summary compensation table, grants of plan-based awards table and director compensation table. Awards subject to performance conditions are to be computed based upon the probable outcome of the performance condition(s) as of the grant date, consistent with the grant date estimate of compensation cost to be recognized over the service period, excluding the effect of

forfeitures. Footnote disclosure of an award's potential maximum value will be required in the summary compensation table and director compensation table. Previously, companies had to disclose the dollar amount recognized for financial statement reporting purposes for the fiscal year in accordance with generally accepted accounting principles. The SEC acknowledged that large grants could result in the displacement from the summary compensation table of officers who would otherwise be expected to be included.

These revisions will apply to companies with fiscal years ending on or after December 20, 2009. Companies will need to recompute the value of stock and option awards disclosed in the summary compensation table for each preceding fiscal year required to be included in the table so that the stock awards and option awards columns present the applicable full grant date fair values. The total compensation column will also need to be recomputed. Companies will not be required to include different named executive officers for any preceding fiscal year based on recomputing total compensation for those years pursuant to these revisions.

### ***Information Concerning Directors or Nominees***

The new rules amend Item 401 of Regulation S-K to provide that, for each director, including those not up for re-election in a particular year, or nominee for election as a director, disclosure be included in the Forms 10-K, registration statements or proxy or information statements, as applicable, that discusses the particular experience, attributes or skills that led to the conclusion the person should serve as a director. Companies are also required to disclose any public company directorships held by each director and nominee at any time during the past five years (at present, only current board memberships are required to be disclosed). This disclosure is required in both management and non-management proxy statements (*i.e.*, those prepared by dissident shareholder groups).

The amendment also lengthens from five to 10 years the time period during which a company must disclose the occurrence of certain legal proceedings involving directors, director nominees and executive officers, and requires the additional disclosure of these individuals' involvement in the following types of legal proceedings:

- 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 of such actions; and
- Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

The new rules amend Item 407 to require disclosure whether a nominating committee considers "diversity", however defined by the company, in identifying director nominees, and, if diversity is considered, in what way. If a nominating committee or board has a policy regarding the consideration of diversity, disclosure of how this policy is implemented, as well as how the policy's effectiveness is assessed, will be required.

### ***Board Leadership***

The SEC amended Item 407 of Regulation S-K to require a discussion of the board's leadership structure in its proxy or information statements. The company must discuss whether and why it has combined or separate principal executive officer and board chair positions and, if they are combined, whether the board has a lead independent director and the specific role the lead independent director plays in the leadership of the company. This disclosure needs to indicate why the company has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the company. In addition, the company must disclose the extent of the board's role in the company's risk oversight process and the effect that this has on the company's leadership structure.

### ***Compensation Consultants***

Pursuant to amended Item 407 of Regulation S-K, companies will be required to disclose in their Forms 10-K or proxy or information statements, as applicable, fees paid to certain compensation consultants when such consultants play a role in determining or recommending the amount or form of executive or director compensation and the consultants also provide certain non-executive compensation consulting services to the company. Under the new rules, if the board, compensation committee or other persons performing equivalent functions (collectively, the "board") engages its own consultant to provide advice on executive or director compensation and the board's consultant provides non-executive compensation consulting services to the company and the fees for those additional services exceed \$120,000 during the fiscal year, the company will be required to disclose the aggregate fees paid to the board's consultant. If the board has not engaged its own consultant, fee disclosure will be required if a consultant provides to the company or management executive compensation and non-executive compensation consulting services, and the fees for such non-executive compensation consulting services exceed \$120,000 during the fiscal year. However, compensation consulting fee disclosure will not be required for consultants retained by the company or management to provide executive compensation consulting services if the board has its own consultant, even if the consultant retained by the company or management provides non-executive compensation consulting services to the company.

If disclosure is required, the company will be required to disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for non-executive compensation consulting services. In addition, where the board has engaged its own compensation consultant and disclosure is required, companies are required to disclose whether the decision to engage the compensation consultant for the non-executive compensation consulting services was made, or recommended, by management, and whether the board approved such non-executive compensation consulting services.

These amendments do not apply to those situations in which the compensation consultant's only role in recommending the amount or form of executive or director compensation is (1) 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, or (2) is in connection with consulting on broad-based plans that do not

discriminate in favor of executive officers or directors of the company, such as 401(k) plans or health insurance plans.

### ***Accelerated Reporting of Voting Results***

By approving these new rules, the SEC transferred the requirement to disclose voting results of any matter submitted to a vote of the company's shareholders from Form 10-Q or 10-K to new Item 5.07 of Form 8-K. Companies will be required to disclose voting results within four business days after the end of the meeting, which period shall begin to run on the day on which the meeting ended, instead of in the fiscal quarter following the fiscal quarter in which the vote was held. In a contested election of directors, companies will only need to disclose preliminary results within four business days after preliminary results are determined if definitive results were not determined at the end of the meeting. Within four business days of the certification of the final voting results, the company will be required to disclose such results in an amendment to such Form 8-K.

### ***Broker Voting***

While not part of the amendments discussed above, we note that as a result of the July 1, 2009 amendment to New York Stock Exchange Rule 452, brokers are prohibited from voting in an uncontested election of directors without shareholder instruction because an uncontested election is now considered a "non-routine" matter.

As a precautionary measure, companies may consider including at least one "routine" matter in their annual meeting proxy statement, such as the ratification of auditors, to ensure that broker discretionary votes will be counted towards the quorum requirement for convening a shareholders' meeting.

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Please feel free to contact any of the partners listed below or any corporate partner with whom you work if you would like to discuss the amendments to the SEC's rules and regulations and their potential ramifications.

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