Cooley

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On December 16, 2009, in response to the recent demand by investors for increased transparency and corporate accountability, the Securities and Exchange Commission approved **new rules** requiring enhanced proxy disclosure.

These rules will affect company disclosures regarding executive compensation, the impact of compensation policies and practices on risk, director and nominee qualifications and legal proceedings, the consideration of diversity in connection with board nominations, the board's leadership structure, the board's role in risk oversight, and potential conflicts of interest involving compensation consultants. The SEC also revised Form 8-K to require disclosure of stockholder voting results, which previously were reported in Forms 10-Q and 10-K. The new rules will be effective February 28, 2010 for companies with fiscal years ending on or after December 20, 2009, and so will apply during the 2010 proxy season.

This *Alert* summarizes the key provisions of the new rules and provides commentary and recommendations for actions companies may want to take in response to the new requirements.

Disclosure of compensation policies and practices as they relate to risk management—Regulation S-K, item 402(s)

In the wake of recent financial turmoil in the U.S. and abroad, some have questioned whether compensation programs and incentive systems led to excessive or inappropriate risk-taking by employees. The new rules attempt to address that issue by requiring increased transparency regarding the relationship between a company's compensation policies and practices and its exposure to material risk.

Under the new rules, a company will be required to provide narrative disclosure about how its compensation policies and practices relate to risk management practices and risk-taking incentives, but only *if* the compensation policies and practices create risks that are *"reasonably likely to have a material adverse effect on the company."* The disclosure threshold in the final rule is significantly higher than the threshold initially proposed, which the SEC fortunately recognized could have required companies to provide speculative disclosure. Companies that have policies and practices that mitigate or balance risk-taking incentives, such as rigorous clawbacks or hold-to-retirement or other substantial holding policies, may take these features into account in evaluating whether any risks are created that meet the threshold. The SEC acknowledges that a company may conclude, under appropriate circumstances, that the risks arising from its compensation policies and practices are *not* reasonably likely to have a material adverse effect on the company, and, as a consequence, omit the enhanced narrative disclosure.

The new rule is essentially principles-based, so whether disclosure is required will vary depending upon the particular company and its compensation programs. For illustrative purposes, the rules contain a non-exclusive list of situations where compensation programs have the potential to create material risks. For example, the potential for creation of material risks may exist where a company's compensation practices vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon the accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

If it is determined that disclosure is required, the discussion should address issues such as the following: the design philosophy of the policies as they affect risk-taking; risk assessment or incentive considerations in structuring compensation policies and practices; how compensation policies relate to the realization of short-term and long-term risks, such as through policies requiring clawbacks or imposing holding periods; policies regarding adjustments to address changes in risk profile and actual adjustments made; and the extent of monitoring of compensation policies to determine if risk management objectives are being met.

Recommendations and commentary

- Companies will need to perform an analytical assessment of the impact of their compensation programs and policies on enterprise risk to enable them to reach a reasoned, well-documented conclusion as to whether disclosure is required under the rule. This may be an especially difficult exercise for companies outside the financial services arena. We recommend that, as an initial step, companies identify and summarize all existing compensation programs, policies and practices (whether written or unwritten), including, where appropriate, compensation policies and practices that are designed to mitigate risk. Companies will also need to catalog the key risks facing them (including at individual units) that may be affected by employee actions or behavior. Key risks often relate directly to a company's overall strategy, and identifying primary risks usually starts with an understanding of the key drivers of the company's success. Once the risks and programs have been identified, the company will be required to evaluate whether any of its compensation policies or practices may serve to create or exacerbate those risks and whether there is any company policy or practice that has a mitigating effect. To evaluate whether any risk identified through this process is reasonably likely to have a material adverse effect, the company will need to take into account the risk's potential severity, probability, timing and associated cost, as it is reasonably likely to affect the company as a whole. Unless the materiality threshold is exceeded, there is no requirement to disclose whether an assessment was performed or the results of that assessment; nevertheless, companies may want to consider including disclosure for transparency purposes.
- RiskMetrics Group may provide a useful data point here. It has identified the following company policies and practices as having the potential to incentivize excessive risk-taking:
- Guaranteed bonuses;
- A single performance metric used for short- and long-term plans;
- Lucrative severance packages;
- High pay opportunities relative to industry peers;
- Disproportionate supplemental pensions; or
- Mega annual equity grants that provide unlimited upside with no downside risk.
- To the extent that a company determines that any of its compensation policies and practices creates risks that are reasonably likely to have a material adverse effect on the company, we recommend that it consider adopting some form of mitigating policy or practice, for example, holding periods that are structured to account for the time horizon of risks.

Enhanced information about directors and board nominees—Regulation S-K, item 401(e) and (f)

To enhance investors' ability to make informed voting and investment decisions, the SEC has mandated new enhanced disclosure requirements about the qualifications of directors and nominees. For each director and nominee, companies will be required to disclose the following:

- The particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company (as of the time of the filing containing the disclosure). This disclosure is required to be provided annually, on a person-by-person basis, and is in addition to the current requirement to disclose the specific minimum qualifications or skills used by the nominating committee in identifying candidates.
- Directorships at public companies and registered investment companies that each director and director nominee held at any time during the past five years (not just current board positions, as required under existing rules).
- Certain legal proceedings involving the director or nominee within the past ten years, instead of the current five years. (Note that this requirement also applies to executive officers.) The new rules also expand the list of the types of proceedings for which disclosure is required, which now include proceedings in which the director (or executive) was the subject of or party to disciplinary actions by self-regulatory organizations (such as the exchanges or NASD) or judicial or administrative orders, judgments or settlements involving mail or wire fraud or based on violations of federal or state securities, commodities, banking or insurance laws. Settlement of a civil proceeding among private litigants would not require disclosure.

Recommendations and commentary

- Each company will need to review with its nominating committee (or board) and summarize the attributes or experience that the committee believes qualify each director to serve on the board as of the time of the disclosure. So-called "soft skills," such as collegiality and integrity, are likely to be qualities attributable to all members of the board and might be discussed in an overview paragraph that puts in context the board's process of identifying directors. However, the SEC has been insistent that the disclosure of each director or nominee's experience, qualifications, attributes, and skills must be provided on an individual basis, and it will not suffice to disclose, for example, that several of the company's directors have been CEOs or that a person should serve as a director because he or she is an audit committee financial expert. Instead, a company should describe why the person's *"particular and specific"* experience, qualifications, attributes, or skills led the board to conclude that this particular person should serve as a director. Prior international experience, industry experience, risk assessment skills, expertise in finance, marketing or executive compensation, prior government or public policy positions, or special leadership skills are likely to be among the skills and attributes considered, depending upon the particular needs of the board and the company.
- The SEC staff has noted that the rule is designed to elicit current information about the qualifications of all directors, regardless of whether each director (or class of directors on a classified board) is nominated for re-election in the current year. That is, the evaluation as to why the director should continue serving on the board should be as of the time that a filing containing the disclosure is made, not at the date of original or last nomination to the board. As a result, companies may need to revisit their disclosure controls and procedures to ensure that they elicit current information about all directors.
- At a minimum, companies will also need to review and revise their standard director and officer questionnaires to elicit the new required information about legal proceedings and directorships or circulate supplemental questionnaires as necessary.
- As is currently the case, no disclosure would be required about legal proceedings if the proceedings were not material to an evaluation of the ability or integrity of the director or nominee; however, because the SEC's threshold for materiality in these cases is remarkably low, it has usually been, and is likely to continue to be, difficult to conclude that an event involving any of the enumerated legal proceedings is immaterial and thus not disclosable.

Disclosure regarding how diversity is considered in the director nomination process—Regulation S-K, item 407(c))

Companies will now be required to disclose whether, and if so how, their nominating committees consider diversity in identifying nominees for director. If a nominating committee or board has a policy regarding the consideration of diversity in identifying director nominees, the company will be required to disclose how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy. The rules do not define "diversity." As a result, each company will have the flexibility to define the concept as broadly or narrowly as appropriate and could include in its definition differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, as well as race, gender and national origin.

Recommendations and commentary

- Some ambiguity exists as to what constitutes simply an aspirational statement or goal, as opposed to a formal policy, and, as a result, it may be challenging to determine whether disclosure about implementation and effectiveness is required. A company without a diversity policy may want to indicate, where appropriate, that, while the company does not have a policy regarding board diversity, it is one of a number of factors that the committee typically takes into account in identifying nominees. A nominating committee or board that wants to adopt a formal diversity policy may either create a separate policy or include the policy in the committee charter or corporate governance guidelines, keeping in mind that the rules will require disclosure about implementation and assessment of the effectiveness of the policy.
- Each company that has a formal diversity policy regarding director nominees should review that policy and then carefully analyze the manner of its implementation—such as through instructions to consultants who assist the nominating committee in identifying potential candidates or through committee discussion—and its assessment processes before crafting its response to this disclosure requirement.

Disclosure of information regarding the board's leadership structure and the board's role in risk oversight—Regulation S-K, item 407(h)

To provide increased transparency about board functions, each company will be required to disclose the structure of its board leadership—essentially, whether and why it has chosen to combine or separate the principal executive officer and board chair positions—and the reasons why the company believes its board leadership structure is most appropriate for that company (at the time of the filing). If the roles of principal executive officer and board chair are combined, the company will be required to disclose whether and why it has a lead independent director and, if there is one, the specific role the lead independent director plays in the leadership of the board. As opposed to many of the SEC's disclosure requirements, which frequently appear to represent efforts at "regulation by humiliation," the SEC has expressly stated that these rule changes are not intended to influence a company's decision regarding its board leadership structure.

The company will also be required to describe the board's role in the oversight of the company's risk management process, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure. According to the SEC, this disclosure is intended to provide information 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."

Recommendations and commentary

- Companies that have combined the role of CEO and board chair and have appointed a lead independent director may want to take this opportunity to review the responsibilities and authority of the lead independent director position. RiskMetrics Group has published guidelines identifying the responsibilities it views as critical to empowering a lead independent director, including the authority to chair executive sessions of the board, ability to call meetings and approve agendas, and responsibility to act as a liaison between the board chair and the independent directors. Companies with combined CEO/board chair positions that have not appointed lead independent directors may want to consider doing so, where appropriate, as a matter of good corporate governance.
- Given the position of many shareholder activists on the issue of independent board chairs, companies that have combined the positions of CEO and board chair may find themselves playing defense on this issue. However, some academic studies have concluded that splitting the roles of CEO and board chair does not necessarily affect corporate performance nor is it necessarily the optimal structure for every company. For some companies, a CEO/board chair may be in a better position to act as a bridge between management and the board, better facilitating the regular flow of information. Some companies also believe that combining the roles helps to ensure that the board and management act with a common purpose and avoids divided leadership, which may interfere with good decision-making or weaken a company's ability to develop and implement strategy.
- The requirement for disclosure about the board's approach to risk oversight appears to be designed to elicit information about board *processes* and *relationships* with management. A company might address, for example, whether the board administers its risk oversight function through the whole board or through a separate risk committee or the audit committee, whether the board's standing committees support the board by addressing risks inherent in their respective areas of oversight, whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as whole or to a committee (or how the board or committee otherwise receives information from these individuals), and how these functions are coordinated, explaining how the board, or board committee, monitors risk.

Revisions to the Summary Compensation Table—Regulation S-K, item 402(c), (d) and (k)

In a reversal of position, the SEC will once again require that companies report in the Summary Compensation Table the aggregate full grant date fair values (computed in accordance with FASB ASC Topic 718) of options and stock awards granted to executives during the fiscal year. Previously, companies were required to report the annual accounting charge recognized for the fiscal year. The SEC now believes, however, that disclosure of the aggregate full grant date fair value better reflects compensation committee decisions and is more informative to investors than the previously mandated disclosure. This change will also apply to the Director Compensation Table.

For performance-based awards, the fair value should be computed based on the *probable* outcome of the performance condition as of the grant date (consistent with the FASB ASC Topic 718 grant date estimate of compensation cost to be recognized over the service period, excluding the effect of forfeitures). Companies must still disclose in footnotes the maximum value, assuming achievement of the highest level of performance conditions is probable. These changes will also apply, where applicable, to the Grants of Plan-Based Awards Table and Director Compensation Table.

To facilitate year-to-year comparisons, when providing disclosure for a fiscal year ended on or after December 20, 2009, companies will be required to present recomputed disclosure for each preceding fiscal year required to be included in the Summary Compensation Table (i.e., stock awards and option awards columns should present the applicable full grant date fair values, and the total compensation column should be correspondingly recomputed). However, there is no requirement to include different named executives for any preceding fiscal year based upon recomputed total compensation or to amend prior years' Item 402 disclosure in previous filings.

Recommendations and commentary

- The use of full grant fair value for awards may lead to some anomalous results in determining the named executive officers. Where executives receive large grants with unusually high fair values (such as sign-on grants or otherwise), companies may want to include supplemental explanation in the footnotes to the table, as well as in the CD&A.
- In the release, the SEC confirms that disclosure is required for awards *granted during* the year, not for awards *granted at any time for services performed during* the year. However, the SEC encourages companies to analyze in the CD&A their decisions to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of compensation for the last fiscal year.

Enhanced disclosure regarding compensation consultants—Regulation S-K, item 407(e)

Compensation consultants, or their affiliates, often provide a wide range of services, such as benefits administration, human resources consulting or actuarial services, that may generate more fees for the consultants than their fees for services relating to executive and director compensation (such as recommending the form or amount of executive and director compensation, designing and implementing incentive plans or providing information on industry and peer group pay practices). As a result, there has long been concern, analogous to concerns raised over the provision of non-audit services by auditors, that potential conflicts of interest may call into question the objectivity of the consultant's advice and recommendations on executive compensation.

To provide transparency regarding consultants' additional fees and services, the new rules require companies, in certain circumstances, to disclose the fees paid to compensation consultants and their affiliates:

- If the board (or compensation committee) has engaged a compensation consultant that also provides additional services to the company, the company must disclose the following:
  - The aggregate fees paid to the consultant (or its affiliates) for services to the company or board related to the determination of the amount or form of executive and director compensation, as well as for additional services;
  - Whether the decision to engage the compensation consultant for the additional services was made or recommended by management; and
  - Whether the board approved these additional services.
- If the board has not engaged its own compensation consultant, fee disclosures are still required if a consultant (including its affiliates) provides executive compensation services *and* additional services to the company. Disclosure is required in this instance because the SEC believes that the absence of a compensation consultant engaged by the board to help filter any advice provided by management's consultant raises potential conflict concerns.

Fee disclosure is required only if the fees paid to the consultant for the additional services during the company's last completed fiscal year exceed $120,000.

Disclosure is not required if the board and management have different compensation consultants, even if management's consultant provides additional services to the company, so long as the board's consultant does not provide any additional services to the company. The SEC believes that, in this circumstance, there is less potential for a conflict of interest to arise. This exception will be available without regard to whether management's consultant participates in board meetings.

Also, an exception from the disclosure requirements is available where the consultant's *only* role in determining or recommending the amount or form of executive or director compensation is limited to (a) consulting on broad-based plans (such as qualified 401(k) plans and pension plans) that do not discriminate in favor of executive officers or directors of the company, or (b) providing information, such as a survey, that is not customized for the company or is customized based on parameters that are not developed by the consultant, so long as the consultant does not provide advice or recommendations in connection with the survey information.

Companies will continue to be required to describe the role of the compensation consultant in determining or recommending the amount or form of executive and director compensation, as mandated under the current rules, but disclosure of the nature and extent of additional services provided by the compensation consultant is not required.

Recommendations and commentary

- Large, complex companies that engage one or more consultants may need to inventory the types of services provided by the consultants to ensure that they have complete information. The company's disclosure controls and procedures may also need to be revised to reflect the need to collect this information.
- Legislation currently pending before Congress could affect the engagement of consultants by compensation committees. In its current form, the pending legislation would require any compensation consultant or other similar adviser to the compensation committee to meet standards for independence established by the SEC along with proxy disclosure as to whether the committee retained and obtained the advice of a compensation consultant meeting those independence standards.

8-K reporting of stockholder voting results—Exchange Act Form 8-K, item 5.07

Under the new rule amendments, companies will be required to disclose on Form 8-K the results of a stockholder vote within four business days after the end of the meeting at which the vote was held. The existing requirement to disclose voting results in Forms 10-K and 10-Q is being eliminated. Companies will be required to file the *preliminary* voting results within four business days after the end of the stockholders' meeting, and then file an amended report on Form 8-K within four business days after the *final* voting results are known. Preliminary results are not required to be disclosed if the final results are reported within four business days after the end of the meeting. Corresponding information will be required with respect to matters submitted for shareholder consent.

Recommendations and commentary

- Companies should be sure to add the new Form 8-K to their proxy season timetables and update any applicable disclosure controls and procedures.
- Companies that are concerned about reporting preliminary results should consider adding supplemental information to advise readers that final voting results may differ significantly from those reflected in the preliminary voting results reported in the Form 8-K or otherwise provide proper context for the preliminary voting disclosure.

Effective date and transition

The new rules become effective on February 28, 2010 and generally apply to companies for their fiscal years ended on or after

December 20, 2009.

If a company's fiscal year ends on or after December 20, 2009,

- its Form 10-K for fiscal 2009 and related proxy statement must be in compliance with the new requirements if filed on or after February 28, 2010,
- its preliminary proxy statement must be in compliance with the new requirements if it expects to file its definitive proxy statement on or after February 28, 2010 (even if the preliminary proxy statement is filed before February 28, 2010), and
- its proxy statement, if filed on or after February 28, 2010, must be in compliance with the new proxy disclosure requirements, even if it files its 2009 Form 10-K before February 28, 2010.

If a company's fiscal year ends before December 20, 2009, its 2009 Form 10-K and related proxy statement are not required to be in compliance with the new requirements, even if filed on or after February 28, 2010.

New Item 5.07 of Form 8-K will become effective on February 28, 2010. Any stockholder meeting that takes place on or after February 28, 2010 is subject to the reporting requirement, even if the proxy statement for the meeting was mailed to stockholders before that date.

On the horizon

We expect a significant level of activity in the areas of disclosure and corporate governance in 2010. As noted above, legislation currently pending before Congress could also significantly affect the proxy process and other corporate governance matters. In addition to proposed requirements for independent compensation committees and independent committee consultants, the new legislation contains, among other things, mandates for say on pay. Bills introduced in the Senate have included provisions mandating majority voting, proxy access for shareholder nominations to the board and prohibitions on staggered boards in the absence of shareholder approval or ratification. In addition, the SEC is expected to take up the issue of proxy access early in this new year.

If you have any questions about this *Alert*, please contact one of your Cooley team members or one of the attorneys identified above.

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