CURRENT ENVIRONMENT BRINGS NEW GOVERNANCE CHALLENGES

SEC PROPOSES ENHANCED COMPENSATION AND GOVERNANCE DISCLOSURES AND INCREASES EMPHASIS ON RISK MANAGEMENT AND BOARD OVERSIGHT

In July, the Securities and Exchange Commission (SEC) proposed new rules that will require enhanced disclosures about executive compensation and governance in proxy statements and the annual report on Form 10-K. The proposed changes put greater emphasis on how companies, and boards of directors, manage and oversee risk, both generally and in the context of compensation. The compensation-related proposals require companies to discuss the relationship of their overall compensation approach—applicable to all employees and not just executive officers—to risk. The compensation proposals are consistent with the Obama Administration's view that the compensation structures at many companies reward excessive risk-taking at the expense of the long-term health of such companies.

Other proposed changes include disclosures relating to the company's leadership structure, director and nominee qualifications, potential conflicts of interest by compensation consultants, the reporting of stock and option awards, and timely disclosure of annual meeting voting results.

Comments are due on September 15, 2009. We expect that new rules will be adopted by the SEC soon thereafter and in time for the 2010 proxy season.

Below we summarize the executive compensation, governance, and risk management aspects of the proposals and some areas where companies may wish to focus their attention. A companion advisory discusses how the SEC's proposals fundamentally could alter the solicitation process and director elections.[1]

Leadership Structure; Risk Management and Oversight. Companies would be required to describe their leadership structure, including whether the same person serves as the chairman of the board and chief executive officer, and if so, whether the company has a lead independent director and the specific role that such lead director plays. The disclosure would also have to indicate why the company determined that its leadership structure is appropriate given the specific characteristics or circumstances of the company. In addition, companies would be required to disclose the extent of the board's role in the company's risk management and the effect that this has on the company's leadership structure. The disclosure would provide information to investors about how the company perceives the role

1 *See* "SEC Proxy Proposals Could Put Companies on an Unanticipated Defensive," available at: http://www.arnoldporter.com/public_document.cfm?id=14648&key=18I0.

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of the board and the relationship between the board and senior management in managing material risks. The proposing release states that the disclosure might also address questions such as whether the board implements and manages its risk management function through the board as a whole or through a committee, whether the persons who oversee risk management report directly to the board as a whole or to a particular committee, and whether and how the board or a board committee monitors risk.

Although the board's role is oversight rather than direct management of risks, companies may wish to review and enhance the board's role in risk oversight. Currently, most companies delegate risk oversight to the audit committee, which is often overburdened with other responsibilities. In light of the increased emphasis on risk oversight by the board, companies may want to consider whether to revise their board committee structure to establish a separate risk committee (if they do not already have such a committee), and whether to hire a chief risk officer to report to such committee. Both the "Shareholder Bill of Rights Act of 2009" introduced by Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA), and the "Corporate Governance Reform Act of 2009" introduced by Representative Keith Ellison (D-MN), provide for mandatory establishment of a risk committee comprised entirely of independent directors. Representative Ellison's bill would also require public companies to have a chief risk officer that would report directly to the committee. The proposals, on their face, would lead only to expanded disclosure. However, the nature of those disclosures and comparisons among companies inevitably would lead to an evolution in best practices. Accordingly, company management and the board of directors may want to take a fresh look at the steps the company is taking to manage risk, through an enterprise risk management program or otherwise, and whether such steps are sufficient. Compliance systems set up under the Sarbanes-Oxley Act may not necessarily have a broad enough focus to cover all of the risks which many companies face.

Relationship of Compensation Program to Risk Management. A new section in the Compensation Discussion & Analysis (CD&A) would provide information about how the company's overall compensation policies for employees, including non-executive officers, create incentives that can affect the company's risk and management of that risk.

Disclosure would be required only to the extent that risks arising from a company's compensation policies and practices may have a material effect on the company. The situations that would require disclosure will vary depending on the particular company and its compensation policies. Situations that potentially could trigger discussion and analysis include, among others, compensation policies and practices:

- At a business unit of the company that carries a significant portion of the company's risk profile;
- At a business unit with compensation structured significantly differently than other units within the company;
- At business units that are significantly more profitable than others within the company;
- At business units where the compensation expense is a significant percentage of the unit's revenues; or
- 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.

In addition, examples of issues that companies may need to address in their CD&A include the following:

- 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, as such policies relate to or affect risk-taking by those employees on behalf of the company, and the manner of its implementation;
- The company's risk assessment or incentive considerations, if any, 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 clawbacks 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.

The SEC notes in its proposing release that the application of a particular example must be tailored to the facts and circumstances of the particular company and the SEC's examples are non-exclusive.

If the proposed rules are adopted, companies should give careful consideration to whether any existing compensation policies and practices may create material risks and should be modified, as well as whether any changes should be made to the disclosure in the CD&A. If losses occur, the board could be vulnerable to allegations that it failed to adequately address risks related to compensation practices, whether or not that is in fact the case.

Director and Nominee Qualifications. The proposed rules would expand disclosure about the qualifications of directors and nominees to serve as directors and on board committees, including the specific experience, qualifications, attributes, or skills that qualify such persons to serve as a director or on a particular committee that such person serves on or is chosen to serve on (if known). If material, the disclosure would cover more than the past five years and include information about the person's risk assessment skills, particular areas of expertise, or other relevant qualifications. The reporting period for certain legal proceedings covering directors and nominees would be changed from five to 10 years. Disclosure about other public company directorships held by directors and nominees would cover the past five years rather than only current directorships held.

Companies will need to revise their directors' and officers' questionnaires in order to comply with these expanded disclosure requirements. Companies may wish to spend more time on the biographical information that appears in the proxy statement for company directors and nominees than in past years. The company's directors and nominees may face competition for votes from shareholder nominees if the SEC adopts proxy access rules. In addition, amendments to NYSE Rule 452 that eliminate broker discretionary voting for all director elections, whether contested or not, will apply to shareholder meetings held on or after January 1, 2010. As a result, "withhold the vote" and "vote no" campaigns may increase and have a greater likelihood of success.

Potential Conflicts of Interest by Compensation Consultants. Currently, companies are not required to disclose fees paid to compensation consultants and their affiliates for executive compensation consulting or other services, or to describe services that are not related to executive or director compensation. The SEC is proposing additional disclosures that are intended to address investor concerns that the executive compensation services provided by compensation consultants or their affiliates may be influenced by the provision of additional services, such as benefits administration, human resources consulting, or actuarial services.

If the proposed rules are adopted, companies would be required to disclose the nature and extent of all additional services provided to the company or its affiliates by a compensation consultant and any of its affiliates during the last fiscal year if they played any role in determining or recommending the amount or form of executive or director compensation. Companies would also be required to disclose the aggregate fees paid for all additional services, and the aggregate fees paid for determining or recommending the amount or form of executive and director compensation.

The proposed new requirements would 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 in connection with consulting on broad-based plans that do not discriminate in favor of executive officers or directors, such as 401(k) plans or health insurance plans.

Companies may wish to limit the services provided by compensation consultants to those relating directly to executive or director compensation and consider adopting written policies related to the independence of such consultants. In addition, companies should be aware that if the decision to engage the compensation consultant or its affiliates is not made solely by the compensation committee without any input from or review whatsoever by management, the company will be required to disclose whether the retention decision was made, recommended, subject to screening, or reviewed by management, which could raise questions regarding the independence of such consultants. Finally, compliance may be difficult for some companies because the proposed rules do not contain a materiality standard, and a number of compensation consulting firms or affiliated entities offer a broad range of advisory services. This is more likely to be a problem for corporations with multinational operations that pay fees for the services of compensation consultants and affiliated firms on a recurrent basis. If the SEC's proposed rules are adopted in the current form, companies may need to strengthen their disclosure controls and procedures to identify relationships with compensation consulting firms and their affiliates and associated fees. Companies may also wish to comment upon the lack of a materiality standard in the proposed rules.

Reporting of Stock and Option Awards. The proposed rules would reverse the interim final rules adopted by the SEC in December 2006 and again require companies to disclose the aggregate grant date fair value of stock awards and option awards made during the year to named executive officers and directors in the Summary Compensation Table and the Director Compensation Table. Currently, companies disclose the dollar amount recognized during the covered year for financial statement reporting purposes for all equity awards outstanding for a named executive officer or director (whether such awards were granted during the fiscal year or a prior fiscal year). The aggregate grant date fair value presently appears in the Grant of Plan Based Awards table.

It is not clear why the SEC now rejects the December 2006 actions in which it concluded that the rules, as now in effect, "would provide a fuller and more useful picture of executive compensation than our recently adopted rules." The proposing release states that disclosure of full grant date fair value will enable investors to better evaluate the amount of equity compensation awarded during the covered year. In addition, because total compensation is the basis for determining which executives, in addition to the chief executive officer and principal financial officer, are named executive officers in the Summary Compensation Table, the SEC believes that a full grant date fair value measure would better align the identification of named executive officers with company compensation disclosure.

Accelerated Disclosure of Voting Results. The SEC proposes to transfer the requirement to disclose the voting results of any matter submitted to a shareholder vote from Forms 10-Q and 10-K to Form 8-K. If the proposed rules are adopted, companies will need to file an amended Form 8-K with the final voting results within four business days after the end of the meeting at which the vote was held. If the matter voted upon at the meeting relates to a contested election of directors and the voting results are not definitively determined at the end of the meeting, the company would disclose the preliminary voting results on Form 8-K within four business days after the preliminary voting results are determined, and then file an amended report on Form 8-K within four days after the final voting results are certified.

We hope you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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