SEC APPROVES ENHANCED PROXY DISCLOSURES—WHAT TO DO IN ADVANCE OF YOUR 2010 ANNUAL MEETING

On December 16, 2009, the US Securities and Exchange Commission (SEC) adopted "Proxy Disclosure Enhancements" about risk, compensation, and other corporate governance matters. The final rules are discussed in a 129-page adopting release (*available at:* http://www.sec.gov/rules/final/2009/33-9089.pdf) and have an effective date of February 28, 2010. Despite the length of the final release and the complexity of the new disclosure requirements, the SEC failed to provide any phase-in period for compliance. In Compliance and Disclosure Interpretations (CD&I) posted on December 22, 2009, the SEC's Division of Corporation Finance, in fact, accelerated the compliance date for some filers. The interpretations, among other things, provide for the following compliance schedule:

- if the company's fiscal year ends on or after December 20, 2009, its Form 10-K and proxy statement must be in compliance with the new proxy disclosure requirements if filed on or after February 28, 2010.
- if such a company is required to file a preliminary proxy statement and expects to file its definitive proxy statement on or after February 28, 2010, then the preliminary proxy statement must be in compliance with the new proxy disclosure requirements, even if filed before February 28, 2010.
- if such a company files its 2009 Form 10-K before February 28, 2010 and its proxy statement on or after February 28, 2010, the proxy statement must be in compliance with the new proxy disclosure requirements.
- if the 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 proxy disclosure requirements, even if filed on or after February 28, 2010.

The rules are intended to provide investors with better and more relevant information when making voting decisions, to increase board accountability through increased transparency, and to require accelerated reporting of shareholder voting results. In particular, the rules are intended to give investors a better understanding of:

- whether a company's compensation policies and practices provide incentives to employees to take excessive or inappropriate risks that are "reasonably likely to have a material adverse effect" on the company;

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- why a board has chosen its particular leadership structure and the board's role in risk oversight;
- the background and qualifications of directors and nominees;
- legal actions involving a company's executive officers, directors, and nominees;
- whether diversity (as defined by the company) is considered in identifying nominees for election as directors;
- the value of stock and option awards granted to company executives and directors; and
- whether the compensation consultant retained by the board's compensation committee or its affiliates performs other work for the company that could create a conflict of interest.

The new disclosure rules will require most companies to take immediate actions to prepare for 2010 annual meetings. These include:

- revising, or preparing supplemental, director and executive questionnaires to capture information regarding past legal proceedings, past directorships held by directors, and information that will be assessed by the nominating committee or board in articulating the qualifications of individual directors and director nominees;
- developing a process and scheduling time for the board or appropriate committee to assess each individual director's experience, qualifications, attributes, or skills to be formally evaluated and for drafting disclosures;
- developing a process and scheduling sufficient time for the nominating or governance committee, and for the full board, to formally assess the board leadership structure and any board policies for the consideration of diversity in board composition, including assessing the effectiveness of those policies;
- assessing whether employee compensation policies and practices (not just for senior executives) create risks that are reasonably likely to have a material adverse effect on the company;
- determining whether the enhanced compensation consultant disclosures will apply, and if so initiating the process to identify and gather fee and required information on all engagements by the company and its subsidiaries (worldwide) of the consultant and any of its affiliates that are covered by the final rules; and
- assessing the effect of grant date fair value reporting of equity awards on the determination of the company's named executive officers.

The new rules are summarized in more detail below.

DISCLOSURE OF COMPENSATION POLICIES AND PRACTICES AS THEY RELATE TO RISK

To the extent that risks arising from a company's compensation policies and practices for employees are "reasonably likely to have a material adverse effect" on the company, the final rules require a discussion of the company's compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company's risk and management of that risk. To the extent applicable, the narrative disclosure about the company's compensation policies and practices would apply to all employees, not just executive officers.

As adopted, the new disclosure requirements will not be a part of a company's Compensation Disclosure & Analysis (CD&A). The SEC was persuaded by arguments that it would be potentially confusing to expand the CD&A beyond the named executive officers to include disclosure of the company's broader compensation policies and practices for employees.

To prepare for 2010 annual meetings, companies should assess whether employee compensation policies and practices (not just for senior executives) create risks that are "reasonably likely to have a material adverse effect on the company." Although the SEC has provided some guidance in the release regarding how this standard should be interpreted and applied, it is not entirely clear how the new standards will be interpreted by the SEC staff and how many companies will be affected by the new rules.

From the proposing release issued in July 2009, it appears that the SEC is attempting to address the concern of commentators that compensation practices may have been one of the factors contributing to the recent financial crisis. However, as Commissioner Casey pointed out at the meeting, the SEC's new rules apply not only to large financial institutions, but to all public companies, the vast majority of which played no role in the crisis.

The SEC appears to be concerned that, at some companies the interests of employees, in the form of incentive compensation arrangements, are not sufficiently aligned with the long-term interests of the company. Consequently, companies will need to conduct a comprehensive risk assessment of compensation policies and practices for all employees (not just those covering senior executives) to determine whether the structure and particular application of such policies and practices are reasonably likely to have a material adverse effect on the company, and disclosure is required.

To the extent that disclosure is required, it will vary depending on the particular company and compensation policies and practices. New Rule 402(s) of Regulation S-K provides examples of policies and practices that may trigger disclosure and provides several illustrative examples of issues that would potentially be appropriate to address.

The "reasonably likely" disclosure threshold should be familiar to companies because the SEC states that the approach being adopted is analogous to the disclosure thresholds in Management Discussion and Analysis (MD&A) rules, which require risk-oriented disclosure of known trends and uncertainties that are material to the business. For purposes of MD&A, and therefore the new required disclosures, the probability/magnitude test for materiality approved by the Supreme Court in *Basic* v. *Levinson,* 108 S.Ct. 978 (1988), is *not* the applicable standard.[1] Based on earlier MD&A interpretive guidance,[2] we assume that companies will be expected to use a two-part test to assess risk:

1. Do the company's compensation policies and practices provide incentives to employees to take excessive or inappropriate risks? If management determines that it is not reasonably likely, no disclosure is required.
2. If the company cannot make that determination, it must evaluate objectively its compensation policies and practices on the assumption that the risks will come to fruition. Disclosure is then required unless the company determines that such risks are not reasonably likely to have a material adverse effect on the company.

The adopting release confirms that the final rules do not require a company to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company. According to statements made by Meredith Cross, the Director of the Division of Corporation Finance, companies should look at offsetting and mitigating factors. For example, the company may have one type of compensation that incentivizes employees to take risks, while another part of the company may be responsible for making sure that such risks are within the company's risk profile.

In light of the changes to the applicable standard that the SEC made in the final release, and the ability of companies to take into account offsetting and mitigating risks, we believe that after conducting a complete assessment of their compensation policies and practices, many companies may be able to conclude that no additional disclosure is required.

BOARD LEADERSHIP STRUCTURE AND THE BOARD'S RISK OVERSIGHT ROLE

The SEC approved rules about a company's board leadership structure and the board's role in risk oversight. The rules require disclosure about:

- A company's board leadership structure, including whether the company has combined or separated the chief executive officer and chairman position, and why the company believes its structure is the most appropriate for the company at the time of the filing.
- Where the role of the chief executive officer and chairman are combined, whether and why a company has a lead

1 *See* Release No. 33-6835, Interpretive Release: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures (May 18, 1989) [54 FR 22427] (the 1989 Release), at n. 27.

2 *See* the 1989 Release, *id.*, where the SEC identified a two-part assessment that management must make in MD&A where a trend, demand, commitment, event, or uncertainty is known.

independent director, and the specific role that the lead director plays in the leadership of the company.

- The extent of the board's role in the "oversight" of risk, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure. The final rules give companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. The final rules refer to "risk oversight" by the board rather than "risk management," as originally proposed, because company executives are responsible for risk management, subject to oversight by the board. Where relevant, the SEC suggests that companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee, or how the board or committee otherwise receives information from such individuals.

ENHANCED INFORMATION ABOUT DIRECTORS AND NOMINEES; LEGAL PROCEEDINGS

The new rules require disclosure of the particular experience, qualifications, attributes, or skills of each director and director nominee that led to the conclusion that the person should serve as a director of the company, in light of the company's business and structure, at the time the disclosure is made. This new disclosure will be required for all nominees and all directors, including those not up for reelection in a particular year.

Although the final rules do not require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a committee member, as had been proposed, the final rules require companies to justify their selection of all directors and nominees on an annual basis based on standards established by the SEC. As Commissioner Casey noted in her dissenting speech, the SEC's "person-to-person" approach interferes with the board's selection process, and does not accurately reflect the process which boards actually use to select directors. Most boards consider an individual director's qualifications based on the board's overall composition and needs, so that the board in its entirety has the necessary skills and experience to oversee the company's business.

The final rules also require disclosure of any directorships at public companies and registered investment companies that each director and director nominee held at any time during the past five years. In addition, legal proceedings involving directors, nominees, and executive officers, such as SEC securities fraud enforcement actions against the director or nominee, must be disclosed for the past 10 years, instead of the current five years, and the list of legal proceedings covered by the rule has been expanded.

Companies may wish to revise, or prepare supplemental, director and executive questionnaires to capture information regarding past legal proceedings, past directorships held by directors, and information that will be assessed by the nominating committee or board in articulating the qualifications of individual directors and director nominees. Companies may also wish to develop a process and schedule time for the board or appropriate committee to assess each individual director's experience, qualifications, attributes, or skills to be formally evaluated and for drafting disclosures.

CONSIDERATION OF DIVERSITY IN THE DIRECTOR NOMINATION PROCESS

Under the final rules, the nominating committee or board must discuss whether, and if so, how, the nominating committee or board considers diversity in identifying nominees for director. If the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, the final rules require disclosure of how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy.

The SEC has not defined the term "diversity" in the rules, recognizing that some companies may wish to define diversity expansively to include differences of viewpoint, professional experience, education, skill, and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. Although companies are free to define the term "diversity" broadly or narrowly, as Commissioner

Casey noted at the meeting, the SEC's "person-by-person" approach may be even more intrusive in the context of diversity requirements. Many boards believe that diversity is an important consideration, and use a broad, holistic approach to diversity when composing their boards. While requiring disclosure regarding how a company considers diversity is consistent with a holistic approach, the final rules also require disclosure regarding how a company implements its diversity policies and how its nominating committee or board assess the effectiveness of these policies.[3]

We believe that many companies take diversity considerations into account when choosing board nominees, although they may not have a formal policy in this area. Although the rules do not require a company to have, or to discuss why they do not have, a diversity policy, companies may wish to consider adopting one to facilitate the disclosures. Alternatively, companies should be prepared to address whether, and if so how, the nominating committee or board considers diversity (as defined by the company) in identifying nominees for director.

REPORTING OF STOCK AND OPTION AWARDS

In a return to the August 2006 version of the executive compensation disclosure rules—subsequently amended in December 2006 before effectiveness[4]—the SEC approved revisions to the reporting of stock and option awards in the Summary Compensation and the Director Compensation Tables.

The final rules once again require companies to report the aggregate grant date fair value of stock and option awards in the Summary Compensation Table and the Director Compensation Table, computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation—Stock Compensation. The requirement to report the aggregate grant date fair value of the awards granted in the fiscal year replaces the current requirement to report the dollar amount recognized for financial statement reporting purposes for the fiscal year, which was hastily adopted in December 2006.

Performance-based awards are treated differently. The value of performance awards reported in the Summary Compensation Table, Grants of Plan-Based Awards Table, and Director Compensation Table will be computed based upon the probable outcome of the performance condition(s) as of the grant date rather than the amount payable for maximum performance. However, the potential maximum award value will be required to be reported in a footnote to the Summary Compensation Table and Director Compensation Table.

Based on the comments received, the SEC decided not to rescind, as it had proposed, the requirement to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table and corresponding footnote to the Director Compensation Table.

The changes in how stock and option awards are to be reported in the Summary Compensation Table and the Director Compensation Table are effective for fiscal years ending on or after December 20, 2009. Transition provisions will require comparative information to be recomputed for the two preceding fiscal years.

Based on a staff CD&I, if a person was not a named executive officer in fiscal years 2007 and 2008, but becomes a named executive officer in 2009, only compensation information for fiscal year 2009 would need to be provided in the summary compensation table.[5] However, the adopting release states that if a person who would be a named executive officer for the most recent fiscal year (2009) also was disclosed as a named executive officer for 2007, but not for 2008, the named executive officer's compensation for each of those three fiscal years must be reported pursuant to the amendments. Companies are not required to include different named executive officers for any preceding fiscal year based on recomputing total compensation for those years pursuant to the amendments, or to amend prior years' Item 402 disclosure in previously filed Forms 10-K or other filings.

3 *See* Speech by SEC Commissioner Kathleen L. Casey, Statement at SEC Open Meeting on Proxy Disclosure Enhancements Rule Adoption (December 16, 2009).

4 *See* SEC Release No. 33-8732A (August 29, 2006), *available at:* http://www.sec.gov/rules/final/2006/33-8732a.pdf and SEC Release No. 33-8765 (December 22, 2006), *available at:* http://www.sec.gov/rules/final/2006/33-8765fr.pdf.

5 *See* CD&I Interpretation, Regulation S-K, at Q. 119.01 [January 24, 2007]. The CD&I was last updated through October 26, 2009.

To prepare for the 2010 annual meeting, companies should immediately assess the effect of grant date fair value reporting of equity awards on the determination of the company's named executive officers for 2009. The SEC's changes may affect the composition of the "named executive officer" group for proxy disclosure purposes and may cause the named executive officer group to change from year to year. One reason that the financial statement recognition model was adopted in December 2006 is the potential for distortion in identifying named executive officers when a single large grant, to be earned by services to be performed over multiple years, is made because such compensation would be treated as compensation in the fiscal year it was granted, even though the executive earns a consistent level of compensation over the award's term.

In adopting the new rules, the SEC does not appear to have considered the effect on other regulations that look to the "named executive officer" definition, including employees who are subject to Section 162(m) of the Internal Revenue Code and those subject to executive compensation provisions under rules enacted pursuant to the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009 (ARRA). Therefore, companies may need to consider whether changes in the list of "named executive officers" that result from the new SEC rules have collateral effects under these other regulations.

POTENTIAL CONFLICTS OF INTEREST BY COMPENSATION CONSULTANTS

Many compensation consultants, or their affiliates, are retained by management to provide a broad range of additional services, such as benefits administration, human resources consulting, and actuarial services. Fees for additional services by a compensation consultant or its affiliate may create a conflict of interest that calls into question the objectivity of the consultant's advice and recommendations on executive compensation. Generally, the final rules require fee and related disclosures in the following circumstances:

- If the compensation committee or board engaged its own compensation consultant on the amount or form of executive and director compensation and the board's consultant or its affiliates also provided additional services to the company or its affiliates in an amount in excess of US$120,000 during the company's last fiscal year, disclosure of the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for such additional services is required. Disclosure is also required of whether the decision to engage the compensation consultant or its affiliates for additional services was made or recommended by management, and whether the compensation committee or board approved these additional services;
- If the compensation committee or board has not engaged a compensation consultant, but management has engaged a compensation consultant to provide advice or recommendations on the amount or form of executive and director compensation and such compensation consultant or its affiliates provided additional services to the company in an amount in excess of US$120,000 during the company's last fiscal year, disclosure of the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the compensation consultant or its affiliates is required;
- Fee and related disclosure for consultants that work with management (whether for only executive compensation consulting services, or for both executive compensation consulting and other non-executive compensation consulting services) is not required if the board has its own consultant; and
- Services involving only broad-based non-discriminatory plans or 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, are not treated as "executive compensation consulting services" for purposes of disclosure.

The US$120,000 disclosure threshold is intended to reduce the compliance burdens on companies when the potential conflict of interest is minimal.

In a change from the proposed rules, the final rules do not require disclosure of the nature and extent of additional services performed by the compensation consultant and its affiliates where disclosure is triggered. The SEC was persuaded by arguments made by commenters that requiring this disclosure could cause competitive harm by revealing confidential and sensitive pricing information.

To prepare for the 2010 annual meeting, companies should immediately determine whether the enhanced compensation consultant disclosures will apply, and if so, initiate the process to identify and gather fee and required information on all engagements by the company and its subsidiaries (worldwide) of the consultant and any of its affiliates that are covered by the final rules. We also expect that more compensation committees will engage their own consultants.

ACCELERATED REPORTING OF VOTING RESULTS

The SEC approved amendments to Form 8-K that would require companies to disclose the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. This replaces the requirement to disclose voting results in Forms 10-K and 10-Q, which often are filed months after the relevant meeting.

If the voting results are not definitively determined at the end of the meeting, companies are required to file the preliminary voting results on Form 8-K within four business days after the end of the shareholders' meeting, and then file an amended report on Form 8-K within four business days after the final voting results are known. To the extent that the company believes that preliminary results may not be indicative of the final results, the company may include additional disclosure in its Form 8-K to put the preliminary voting disclosure in the proper context. This disclosure will be of particular importance in proxy contests since the final results often take several weeks to determine. The amendments are not intended to preclude a company from announcing preliminary voting results during the meeting of shareholders at which the vote was taken and before filing the Form 8-K, without regard to whether the company webcast the meeting.

DEFERRED ACTION ON PROXY SOLICITATION RULES; CURRENT STATUS OF PROXY ACCESS

The July 2009 proposals also included proposed amendments to various proxy solicitation procedure rules. The SEC has deferred acting on these proposals until it takes up its proposed changes to the federal proxy rules to facilitate shareholder director nominations. On December 14, 2009, the SEC reopened the public comment period for its proxy access proposals to seek views on additional data and related analyses received by the SEC at or after the close of the original public comment period. Comments are due January 19, 2010. SEC Chairman Schapiro stated at the meeting that she is committed to bringing final rules on proxy access before the full Commission early next year. In addition, the staff continues to comprehensively review the infrastructure that underpins the proxy process, including reviewing the role of proxy advisers and ensuring the integrity of voting results.

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

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