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SEC Adopts Enhanced Compensation and Governance Disclosure Requirements

At what can only be described as the last possible moment, on December 16, 2009, the Securities and Exchange Commission (the "SEC") voted 4 – 1 to approve rules (the "Final Rules") providing for enhanced compensation and corporate governance disclosure in proxy statements of domestic issuers and more rapid reporting of shareholder voting decisions.[1]

The Final Rules become effective on February 28, 2010. The SEC has provided little guidance on exactly what this means, but it appears that the enhanced disclosure requirements apply to filings made on or after that date. It is hoped that the SEC will issue guidance regarding the treatment of preliminary vs. definitive proxy statements that straddle that date and companies that elect to include Part III compensation information in Form 10-Ks filed before that date.

The Final Rules require companies to provide disclosure regarding:

- the relationship between the company's general compensation policies and practices to risk management practices or risk-taking incentives if the compensation policies and practices are reasonably likely to have a material adverse effect on the company;
- fees paid to external consultants who played a role in determining executive or director compensation while also providing significant non-compensation related services;
- the background and qualifications of directors and nominees to the board;
- board leadership structure and the board's role in risk oversight; and
- how diversity is considered in a company's director nomination process.

The Final Rules revise the method of reporting in the summary compensation table the value of stock or options awarded to executives and directors to equal the aggregate grant date fair value rather than the value recognized each year for accounting purposes. This new requirement applies to disclosures for a fiscal year ending on or after December 20, 2009.

The Final Rules also require that companies disclose shareholder voting results within four business days after the end of the meeting at which the vote was held, replacing the requirement that such disclosures be made in the subsequent Form 10-K or 10-Q, which may be filed months after the relevant meeting.

1 *Proxy Disclosure Enhancements*, Release Nos. 33-9089; 34-61175 (Dec. 16, 2009), *available at* http://www.sec.gov/rules/final/2009/33-9089.pdf.

White & Case is a leading global law firm with lawyers in 36 offices across 25 countries.

If you have questions or comments about this alert, please contact one of the lawyers listed below:

Colin Diamond
Partner, New York
Tel: + 1 212 819 8754
E-mail: cdiamond@whitecase.com

Mark Hamilton
Counsel, New York
Tel: + 1 212 819 8262
E-mail: mhamilton@whitecase.com

Gary Kashar
Partner, New York
Tel: + 1 212 819 8223
E-mail: gkashar@whitecase.com

Kenneth Raskin
Partner, New York
Tel: + 1 212 819 8508
E-mail: kraskin@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

I. Enhanced Compensation Disclosure

Relationship between Compensation Policies and Practices and Risk Management

New Item 402(s) of Regulation S-K requires companies to include in their proxy statement a discussion of the company's compensation policies and practices for all employees, including non-executive officers, as they relate to risk management and risk-taking incentives if the compensation policies and practices create risks that are "reasonably likely to have a material adverse effect" on the company. The SEC has provided a non-exhaustive list of situations that may require disclosure and a list of the type of information that companies should consider disclosing. We have included this information on *Schedule 1* hereto.

The SEC originally proposed making this disclosure part of the Compensation Discussion & Analysis ("CD&A"). However, the SEC was persuaded to move it to a separate section since, unlike the rest of the CD&A, it addresses compensation practices for employees generally and not just for named executive officers.[2] The requirement is not applicable to smaller reporting companies.[3]

Commentary

This aspect of the Final Rules will likely be the most challenging to implement. Companies will need to conduct a new risk assessment to determine whether their compensation policies and practices encourage employees to take risks in order to receive their incentive compensation and whether those risks are reasonably likely to have a material adverse effect on the company. This is not a simple assessment. For example, the development of new products is critical in many industries and research personnel are often incentivized to achieve developmental milestones. These incentives could result in pressure to downplay negative outcomes, which could, when discovered, materially adversely affect the company. Similarly, groups of employees at many companies are incentivized to engage in hedging activities. The activities of these employees can be critical to the company's results. However, incentives based on their success in hedging could lead them to adopt positions with greater downside, as well as greater upside. The point is that every company—not just financial institutions—will need to engage in an analysis to determine whether such policies or practices exist. Then, there may be compensating or offsetting steps or controls designed to limit risks of certain compensation arrangements which mean that, notwithstanding the incentives, there is unlikely to be a material adverse effect on the company. Even if a company's policies are designed to discourage excessive risk-taking, or there are intended to be offsetting controls to manage such risk-taking, disclosure and discussion will still be required if the compensation that is actually paid, or the effectiveness of the controls, ultimately encourages risk-taking that is reasonably likely to have a material adverse effect on the company. Finally, the new standard of "reasonably likely to have a material adverse effect" calls into question how much disclosure will ultimately result from this new requirement. Most boards of directors would presumably strive to avoid compensation policies and practices that would result in such disclosure.

Changes to Summary Compensation and Director Compensation Tables

Item 402(c)(2) of Regulation S-K is amended to require companies to disclose in the Summary Compensation Table and Director Compensation Table the aggregate grant date fair value of stock or option awards in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 718 (formerly, FAS 123R). This replaces the requirement of disclosing the dollar amount recognized each year for financial statement purposes.

The determination of the fair value of stock or option awards should be based on the probable outcome of any performance condition(s) as of the grant date, rather than such awards' maximum value. The Final Rules also require footnote disclosure of such awards' maximum value assuming the highest level of performance conditions is probable.

2 The "named executive officers" are a company's CEO, CFO, the other three most highly compensated executive officers based on total compensation paid in the prior fiscal year and up to two additional individuals for whom disclosure would have been provided pursuant to Item 402 but for the fact that the individual was not serving as an executive officer of the company registrant at the end of the last completed fiscal year.

3 "Smaller reporting company" is defined in Item 10(f)(1) of Regulation S-K and generally consists of companies with a public float of less than US$75 million. These companies are currently exempt from CD&A disclosure requirements.

This aspect of total compensation will be used by companies with fiscal years ending on or after December 20, 2009 to determine the identities of named executive officers. Companies are required to recompute the compensation included in the Summary Compensation Table for those named executive officers for previous years. However, companies are not required to determine whether named executive officers for previous years would change based on the new requirements.

Commentary

The Final Rules generally include some welcome changes for companies and investors. The full grant fair value better reflects compensation decisions taken during the prior fiscal year than the amount of equity compensation recognized during a particular fiscal year. In addition, the old rules could result in negative compensation being recorded for financial statement purposes which serves to reduce total compensation and is confusing to investors.

Nevertheless, use of the grant date fair value may cause significant year-to-year variability in the identity of named executive officers for which compensation disclosure is required. For example, under the Final Rules, a single large grant to be earned for services to be performed over multiple years would be treated as compensation in the fiscal year it was granted, even though the executive may earn a consistent level of compensation over the award's term.

Smaller reporting companies should note that the Final Rules require them to disclose the grant date fair value of awards. The old rules do not require smaller reporting companies to provide a Grants of Plan-Based Awards Table where this information appears for other reporting companies.

II. Disclosure Related to Compensation Consultants

The Final Rules add new disclosure requirements to Item 407(e)(3)(iii) of Regulation S-K regarding the role of compensation consultants in determining or recommending the amount or form of compensation for executive officers and directors.[4] In particular:

- If the board, compensation committee or other persons performing the equivalent functions (collectively, the "board") has engaged its own consultant to provide recommendations relating to executive or board compensation, and such consultant or its affiliates provide other services to the company in excess of US$120,000 during a fiscal year, the company must disclose the aggregate fees paid to the consultant and its affiliates for (i) executive and/or board compensation-related services, and (ii) for other services. The company must also disclose whether the decision to engage the compensation consultant or its affiliates for such other services was made or recommended by management and whether the board has approved such other services.
- If the board has not engaged its own consultant and management has engaged a consultant for executive compensation consulting services, and the consultant or affiliates thereof also provide other services in excess of US$120,000 during a fiscal year, the company must provide similar fee-related disclosures but is not required to make disclosures regarding the decision to engage the consultant or its affiliates for such other services. No disclosure regarding management's consultant is required if the board has engaged its own compensation consultant.

Contrary to what the SEC originally proposed, disclosure related to the nature and extent of other services provided by compensation consultants or their affiliates is not required. Services involving only 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, or the provision of advice that is not customized for the company, such as surveys, or customized based on parameters that are not developed by the consultant, would not be treated as executive compensation consulting services (although the provision of advice based on surveys would).

Commentary

Companies should assess whether they will be required to provide enhanced disclosures as a result of the new requirements. In addition, companies should consider establishing procedures—similar to those adopted by audit committees—to approve the provision of additional services by executive compensation consultants.

4 Item 407(e)(3)(iii) currently requires a description of any role played by compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether they are engaged directly by the compensation committee or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement. It remains unchanged other than incorporating the exceptions described below for broad-based or general advice.

III. Corporate Governance

Enhanced Director and Nominee Disclosure

The Final Rules amend Item 401 of Regulation S-K to require disclosure of the particular experience, qualifications, attributes or skills of each director and nominee for director that led the board to conclude that such person should serve as a director of the company, in light of the company's business and structure. This new disclosure applies to all director nominees and all continuing directors, including those not up for reelection in a particular year. The same disclosure applies to any nominees put forward by third-party proponents in the disclosure materials of such proponents.

The Final Rules do not specify what information should be disclosed. The SEC believes it best to give companies flexibility to determine what aspects of a director's background and qualifications would benefit the company and should be disclosed to shareholders. The Final Rules do not require, as previously proposed, the disclosure of qualifications and prior experience that qualify a person to serve as a committee member.

The Final Rules also expand the disclosure of directorships under Item 401, which previously required disclosure of *current* directorships, to include any directorships held by each director and nominee at public companies at any time during the prior *five years*. The Final Rules also extend the period for which disclosure of legal proceedings is required from five to ten years and requires disclosure regarding a broader range of legal proceedings than was previously required.

The Final Rules amend Item 407(c) to require disclosure of whether, and if so how, a company's nominating committee or board considers diversity in identifying nominees for director. The Final Rules do not define diversity and the SEC states that it believes that companies should be allowed to define diversity as they deem appropriate. If a policy with regard to the consideration of diversity in nominations exists, the company must disclose how such policy is implemented and its assessment of the policy's effectiveness.

Commentary

Companies should decide who makes the determination regarding the qualification of directors and nominees. The nominating committee will be best placed to do this at most companies. Each company will need to develop a framework to make this determination. This will likely require some additional time and effort to implement for the first time. Companies should consider how best to include this disclosure in their proxy statements. One way may be to include information after each director's biography. However, this approach might mask the particular background (as opposed to qualification or experience) that a particular director brings when compared to all other directors. As a result, many companies may benefit from an accompanying narrative, similar to that provided for corporate governance or director independence disclosures.

The new ten-year look-back and expanded range of legal proceedings might capture potentially embarrassing disclosures that were previously not required. Irrespective of the ten-year look-back, we recommend that directors and nominees be required to disclose to the company any legal proceedings that could be considered material to their ability to serve as a director even if they do not fall within the mandatory disclosure requirements. For example, fraud committed before the look-back period may be material under any circumstance.

Finally, it seems likely that many companies without diversity policies will adopt such policies.

Disclosures Regarding Leadership Structure

Item 407 of Regulation S-K is amended to require disclosure in a company's proxy statement or information statement of a company's board leadership structure and why the company believes it is the best structure for it at the time of the filing. This disclosure must include discussion of:

- whether and why the company has chosen to combine or separate the principal executive officer and board chair positions; and
- for companies where those roles are combined, whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company.

The Final Rules also require additional disclosure in proxy and information statements about the extent of the board's involvement in risk oversight and how this impacts the board's leadership structure. Such disclosure should include a discussion of whether risk management is overseen by the board or by a committee of the board, such as the audit committee, and whether reports by individuals responsible for risk oversight are made to the board as a whole or only to such committee.

Commentary

Companies that do not combine the CEO and Chairperson roles will find it difficult to include meaningful disclosure about their leadership structure beyond, perhaps, discussing the size of the board. For those that combine the CEO and Chairperson roles, there has been an increasing spotlight on this practice for the last few years. In 2009, RiskMetrics reported that 22 companies with combined CEO and Chairperson roles were subject to shareholder proposals to institute an independent Chairperson.

The Final Rules refer to "risk oversight" rather than "risk management" as originally proposed. Rule 303A.07(c)(iii)(D) of the NYSE Listed Company Manual requires that the audit committee of an NYSE have a charter that addresses the committees "purpose," which includes a discussion of "policies with respect to risk assessment and risk management."[5] The boards or audit committees of many companies receive annual or quarterly reports regarding the overall risk facing the company and steps that are advised to reduce or mitigate them. This is an important practice and one that will likely become more prevalent as a result of the new disclosure requirement. Nevertheless, the disclosure requirement remains somewhat open-ended and companies will need to invest some effort in order to avoid boilerplate disclosure.

IV. Current Reporting of Voting Results

The Final Rules require current disclosure of shareholder voting results by transferring the applicable reporting requirements from Forms 10-Q and 10-K to Form 8-K. The SEC believes that if a matter is important enough to submit to a shareholder vote, it is important enough to require current reporting of the results of such vote on Form 8-K. Under the proposals, a new Item 5.07 would be added to Form 8-K requiring a company to disclose the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. If the voting results are not definitively determined at the end of the meeting, companies would be required to disclose on Form 8-K the preliminary voting results within four business days after the preliminary voting results are determined, and file an amended report on Form 8-K within four business days after the final voting results are certified.

5 The related commentary in the NYSE Listed Company Manual states as follows: "While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee."

Schedule 1

The SEC states, by way of example, that disclosure may be warranted regarding the 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 a business unit that is significantly more profitable than others within the company;
- at a business unit 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.

The SEC also gives the following examples of issues that companies may need to address for the business units or employees discussed:

- the general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk-taking by employees on behalf of the company, and the manner of their implementation;
- the company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;
- how the company's compensation policies and practices 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 and practices to address changes in its risk profile;
- material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and
- the extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

For additional information, please contact any of the lawyers listed below from White & Case's Capital Markets practice or Executive Compensation, Benefits, Employment and Labor practice:

Los Angeles **+ 1 213 620 7700**
Daniel H. Peters dpeters@whitecase.com
Neil W. Rust nrust@whitecase.com

New York **+ 1 212 819 8200**
Ronald Brody rbrody@whitecase.com
Colin J. Diamond cdiamond@whitecase.com
David Johansen djohansen@whitecase.com
Mark T. Hamilton mhamilton@whitecase.com
Gary Kashar gkashar@whitecase.com
Kevin Keogh kkeogh@whitecase.com
Jin Kim jkim@whitecase.com
Mark L. Mandel mmandel@whitecase.com
Tomer Pinkusiewicz tpinkusiewicz@whitecase.com
Kenneth A. Raskin kraskin@whitecase.com
Laura Sizemore lsizemore@whitecase.com
Kenneth Suh ksuh@whitecase.com
John Vetterli jvetterli@whitecase.com
Nazim Zilkha nzilkha@whitecase.com

Miami **+ 1 305 371 2700**
Mark O. Bagnall mbagnall@whitecase.com
Kenneth C. Ellis kellis@whitecase.com
Jorge L. Freeland jfreeland@whitecase.com

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