# SEC Adopts Enhanced Proxy Statement Disclosures Focusing on Compensation and Governance

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The Securities and Exchange Commission has adopted a number of new rules that will affect public company disclosures in the areas of compensation, director qualifications and suitability, corporate governance and reporting of the results of shareholder meetings.

In light of these changes, companies may need to adjust their disclosure controls and procedures to take into account the additional information sought by these reforms. Companies will also need to review director selection processes and reconsider their leadership structures in order to explain those processes and structures to shareholders. Equity award programs with features that impact grant date fair values also deserve review.

In general, the new rules take effect for proxy statements, annual reports on Form 10-K and registration statements filed after February 28, 2010 that are required to include relevant information for fiscal years ending after December 20, 2009.

## I. New Rules Affecting Compensation Disclosures

### A. Evaluation of Compensation Practices and Risk Management

Under the new rules, companies (except for those with a public float of less than $75 million, known as smaller reporting companies) must include in their proxy statements a discussion of compensation policies and practices for all employees, including non-executive officers, if such policies and practices create risks, or risk-taking incentives, that are "reasonably likely to have a material adverse effect" on the company. In this context, the SEC says that "reasonably likely" means more than "possible" and less than "more likely than not."

Because the coverage of this discussion is intended to reach beyond named executive officers (NEOs), the discussion should be separate from the Compensation Discussion & Analysis (CD&A) section in the proxy statement – although if the risk issue affects compensation of executives, it may be relevant to some of the CD&A discussion as well. As a reminder, smaller reporting companies are not subject to the CD&A disclosure rules.

Presumably most public companies endeavor to minimize this type of risk. However, there will be many exceptions. For example, companies that depend on the continual development and introduction of new products, such as pharmaceutical companies, may decide to compensate executives and key personnel based on the achievement of development milestones, which may in turn cause such personnel to minimize or even disguise negative outcomes. That tendency could backfire, of course, and adversely affect company results. The SEC has published a number of other examples of the type of risk profiles that could warrant disclosure and discussion.

### B. Revised Disclosure of Stock or Option Awards

A disclosure that will affect all public companies is the significant change in how stock or option awards are required to be reported. Previously, under old Financial Accounting Standard No. 123(R) – now known as FASB Accounting Standards Codification Topic 718 – companies were required to disclose in the Summary Compensation Table and Director Compensation Table the dollar amount of such awards recognized each year for financial statement purposes. In the future, companies must instead disclose the aggregate grant date fair value of such awards, based on the probable outcome of any performance conditions on the date of grant, with footnote disclosure of the maximum value of the awards assuming the performance conditions are met.

This change is designed to reflect more accurately the compensation decisions made during the fiscal year, rather than the amount of compensation recognized during the year. It is likely to result in greater variability both in terms of compensation reported and in terms of the identity of the NEOs in the Summary Compensation Table.

### C. Enhanced Disclosures About Compensation Consultants

Because of concerns about conflicts of interest that may arise in connection with the engagement of compensation consultants who do a significant amount of other work for the company, the SEC has added a requirement to make additional disclosure about the use of compensation consultants in determining the compensation of executive officers and board members.

If the board or compensation committee has engaged its own consultant to make recommendations for executive and board compensation, and the consultant or its affiliates has provided other non-executive compensation consulting services to the company in excess of $120,000 in the fiscal year (the "threshold amount"), then the company must disclose the aggregate of fees paid for compensation related services and the other services, and disclose as well whether the decision to employ the consultant was made at the recommendation of management and whether the board approved the non-executive compensation consulting services.

On the other hand, if the board has not engaged its own consultant but management has, and the consultant or its affiliates has provided other services beyond the threshold amount, then the company must provide similar disclosures about fee-related services but is not required to make disclosures about the decision to engage the consultant for the other non-executive compensation consulting services. If the board has engaged its own compensation consultant, then no disclosure is required about management's compensation consultant.

Services involving only broad-based non-discriminatory plans (e.g., 401(k) plans) or the provision of non-customized information like surveys, are not treated as executive compensation consulting services under these new rules.

## II. New Rules Affecting Board Disclosures and Corporate Governance

### A. Particularized Disclosures about Director Skills and Suitability and Relevant Legal Proceedings

Federal proxy rules have long required at least 5 years of disclosure about the business experience of directors and director nominees. The new rules call for particularized disclosure, extending beyond 5 years when appropriate, about those qualities and attributes that make the director suited for service on the company's board. These clearly articulated rationales must be made on an individualized basis, not a group basis.

In addition, disclosure of service on other public company boards and registered investment companies has been extended to cover the past 5 years, and disclosure of certain legal proceedings will now cover a 10 year period, instead of 5 years as formerly. Those legal proceedings now include proceedings resulting from:

- Mail or wire fraud, and
- Fraud based on violation of federal or state securities, insurance, commodities or banking laws or rules, plus
- Any settlement of such types of actions and disciplinary sanctions by a stock exchange or other self-regulatory organization.

On the other hand, no disclosure is required in the directors' biographical sections about the settlement of civil proceedings among private parties.

### B. Disclosure of Board Diversity Policies

One of the rules changes that is causing some consternation is an amendment that requires companies to disclose whether "diversity" is considered by the nominating committee or the board when identifying and selecting candidates for director. Unfortunately, "diversity" is not defined. Some companies may view it as heterogeneity in outlook and skills, and others may consider the race, gender or national origin of candidates. RiskMetrics Group, a leading exponent of shareholder activism, is interested in the representation on boards of women and members of minority groups. As often happens with this type of regulation, companies may be inclined to address it by adopting policies that address diversity in board composition.

### C. The Principal Executive and the Board Chair – One Job or Two?

The SEC is also requiring companies to disclose whether and why the company has chosen to combine or to separate the functions of principal executive officer and chairman of the board. For those companies where one individual holds both positions, there must be disclosure about why this is appropriate, whether the company has a lead independent director, and what role he or she plays in governance. This is another rule which, while merely calling for disclosure, is likely to affect policy, particularly since RiskMetrics considers this to be an important issue as well.

## III. Faster Reporting of the Results of Shareholder Meetings

The SEC has changed the rule regarding the reporting of the results of shareholder meetings, moving it from the next Form 10-Q filing subsequent to the meeting (which may not be due for several months) to a filing on Form 8-K within four business days after the meeting. Where results cannot be correctly determined within the four business days, Form 8-K must still be filed to report the preliminary vote, and amended when the final vote is known.

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