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SEC Adopts Amendments to Compensation and Corporate Governance Rules

In December 2009, the Securities and Exchange Commission adopted rule amendments[1] generally designed to improve compensation and corporate governance disclosures. The amended rules affect disclosures in proxy and information statements, annual reports on Form 10-K, current reports on Form 8-K and registration statements filed with the SEC under the Securities Exchange Act of 1934, Securities Act of 1933 and Investment Company Act of 1940. The new rules, which do not apply to foreign private issuers, are effective February 28, 2010. Compliance is required for companies with fiscal years ending on or after December 20, 2009 for Forms 10-K and proxy statements filed on or after February 28, 2010. See Part VI of this Alert for SEC guidelines related to the transition to the new rules.[2] Part VII of the Alert lists steps that companies should take now in light of these rule changes to prepare for the 2010 proxy season.

Under the new rules, which focus primarily on additional or enhanced disclosures related to risk management, compensation, director qualifications and corporate governance, a public company will be required to disclose the following:

- the company's compensation policies and practices for ***all*** employees, including non-executive officers, as they relate to risk management practices or risk-taking incentives, if risks arising from such compensation policies and practices are reasonably likely to have a material adverse effect on the company;
- the aggregate grant date fair value of equity awards granted during a fiscal year instead of the dollar amount recognized for financial statement reporting purposes for the fiscal year in the summary compensation table for named executive officers and the director compensation table;
- the particular qualifications that led the board to conclude that a director or nominee for director should serve on the board;
- not only current directorships at public companies held by each director or nominee for director but also any such directorships at any time during the past five years;
- whether diversity was part of the consideration in the nomination of director candidates;
- expanded legal proceedings involving the company's directors, nominees for director and executive officers for the past ten years (as opposed to previously required five years);
- the company's board leadership structure (particularly whether and why the company has chosen to combine or separate the principal executive officer and board chairman positions) and the extent of the board's role in the oversight of the company's risk;

1. *See* SEC Release No. 33-9089, *Proxy Disclosure Enhancements* (December 16, 2009), which is available at http://www.sec.gov/rules/final/2009/33-9089.pdf. As noted in the SEC release and below, certain of the new rules do not apply to smaller reporting companies.
2. *See* SEC Compliance and Disclosure Interpretations: Proxy Disclosure Enhancements Transition (December 22, 2009), which is available at http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm.

- fees paid to compensation consultants and their affiliates who played a role in determining or recommending director or executive compensation and provided additional services, for which their fees exceeded $120,000 in the company's last completed fiscal year; and
- voting results of a shareholders' meeting, which now must be reported on Form 8-K within four business days after the meeting.

Risk Management and Compensation Disclosures

Compensation Policies and Practices for Employees

New Item 402(s) to Regulation S-K, requires a public company, other than a smaller reporting company, to discuss the company's compensation policies and practices as they relate to the company's risk management practices and incentives. Such disclosure is required only if risks arising from the company's compensation policies and practices for its employees, including non-executive officers, are reasonably likely to have a material adverse effect on the company.

The SEC has used a principles-based approach in connection with this type of disclosure and therefore, a determination of whether additional disclosure is required will depend upon the particular company and its corporate policies. However, the SEC has provided a non-exclusive list of situations where compensation programs may raise material risks to companies as well as non-exclusive examples illustrating the issues that would be appropriate for a company to discuss and analyze.

This list of situations that may trigger disclosure under Item 402(s) includes compensation policies and procedures:

- 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 other units within the company;
- at a business unit where the compensation expense is a significant percentage of the unit's revenues; and
- that vary significantly from the overall risk and reward structure of the company (for example, 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's non-exclusive list of issues that a company may need to address once it determines that corporate policies or practices exist that may create risks which are reasonably likely to have a material adverse effect on the company is set forth below:

- 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.

Although the foregoing new requirements have been adopted as a separate disclosure item, the SEC has noted that, to the extent that risk considerations constitute a material aspect of the company's compensation policies or decisions for named executive officers, a discussion of such risk considerations must be included in the existing Compensation Discussion and Analysis disclosure.

Aggregate Grant Date Fair Value of Equity Awards

The SEC has revised the Summary Compensation Table and Director Compensation Table to require disclosure of the aggregate grant date fair value of stock and option awards granted ***during*** the fiscal year computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718 (formerly FAS 123R), instead of the dollar amount recognized for financial statement reporting purposes for the fiscal year.

In connection with any equity awards subject to performance conditions, a company should report the value of the grant at the grant date based on the probable outcome of such conditions in the Summary Compensation Table, Director Compensation Table and, other than smaller reporting companies, the Grants of Plan-Based Awards Table. This amount should be consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date, excluding the effect of estimated forfeiture. In addition, companies are required to disclose in a footnote to the Summary Compensation Table and Director Compensation Table, the value of such awards at the grant date assuming that the highest level of performance conditions will be achieved if an amount less than the maximum is included in the table.

The new disclosure also affects the calculation of the total compensation. As a result, this disclosure impacts the determination of who is a "named executive officer," for purposes of the compensation tables. This change in disclosure requirements may lead to situations where a "one time" grant, for example a new hire or retention award, to an executive officer may result in the inclusion of such executive officer in the Summary Compensation Table and the omission from such table of another executive officer whose compensation would have otherwise been included in the table. The SEC believes that in such situations the company should consider including the compensation of such former named executive officer in the table to supplement required disclosures.

To facilitate year-to-year comparisons in the Summary Compensation Table, companies providing compensation disclosure for a fiscal year ending on or after December 20, 2009 will be required to present ***recomputed*** disclosure for each preceding fiscal year included in the table, so that the stock awards and option awards columns presented the applicable aggregate grant date fair values and the total compensation column were correspondingly recomputed.

The amounts to be reported in stock awards and option awards columns should be computed based on the individual award grant date fair values reported in the applicable year's Grants of Plan-Based Awards Table. However, awards with performance conditions should be recomputed to report grant date fair value based on the probable outcome as of the grant date.

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.

Enhanced Director and Nominee Disclosure

The amended rules expand the required disclosure regarding the qualifications of directors and nominees for director.

The amended rules require annual disclosure for each director (whether or not that director is standing for reelection at that time) and nominee for director of the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as the company's director as of the time that a filing containing this disclosure is made with the SEC. If material, such disclosure should cover more than the past five years, including information about the person's particular areas of expertise or other relevant qualifications. The same disclosure would be required in the proxy soliciting materials of a proponent of any other director nominee.

The SEC believes that if an individual is chosen to be a director or nominee for director because of a particular qualification, attribute or experience related to service on a specific committee (such as the audit committee), this experience should be disclosed as part of that individual's qualifications to serve on the board. Similarly, although the SEC did not adopt the requirement to describe the risk assessment skills of a director or nominee for director, if particular skills, such as risk assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board or proponent to conclude that the person should serve as a director, this should be disclosed.

In addition, the SEC adopted amendments to:

- require disclosure of directorships held by a director or nominee for director at public companies during the past five years (even if the director or nominee no longer serves on that board), instead of disclosing only existing directorships as previously required; and
- increase the look-back period for disclosure of specified legal proceedings involving directors, nominees or executive officers from five to ten years in order to give investors more extensive information regarding an individual's competence and character.

The SEC also expanded the types of legal proceedings involving directors, nominees or executive officers which must be disclosed to include the following:

- any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;
- any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws or regulations, or any settlement to such actions (excluding disclosure of a settlement of a civil proceeding among private parties); and
- any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Finally, the SEC adopted amendments requiring disclosure in proxy and information statements of whether a nominating committee or the board considers diversity when 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, disclosure should include a description of how the policy is implemented as well as how the nominating committee or the board assesses the effectiveness of its policy. The SEC did not defined the term "diversity" and allowed companies to define "diversity" in ways that they consider appropriate. The SEC commented that companies may define diversity in various ways to include differences of viewpoint, professional experience, education, skills and other individual qualities or to focus on diversity concepts such as race, gender and national origin.

Board Leadership Structure and the Board's Role in the Risk Management Process

The amended rules require a company to describe in a proxy or information statement its board leadership structure and why the company determined that its board leadership structure was appropriate given the specific characteristics or circumstances of the company. The company will be required to disclose whether and why it chose to combine or separate the principal executive officer and board chairman positions. If the company has a combined principal executive officer and board chairman position, the company should disclose whether the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the board.

In addition, the company would be required to disclose the extent of the board's role in the risk oversight, for example, whether the whole board or a separate risk committee or the audit committee administers the risk oversight process. The SEC suggested that companies may also disclose, if relevant, whether persons who supervise the day-to-day risk management report directly to the board or a board committee and, if not, how the board or the board committee otherwise receives information from such persons.

Disclosure Related to Compensation Consultants

The SEC's amended rules require additional disclosure about compensation consultants and their affiliates if they (i) were engaged by the board, compensation committee, or other persons performing similar functions, to provide advice or recommendations related to the executive and director compensation, and (ii) provided additional services to the company or its affiliates and the fees for such additional services exceeded $120,000 during the company's last completed fiscal year. The amendments require disclosure of the following information related to the use of compensation consultants in the company's proxy or information statements:

- the aggregate fees paid to the consultant for determining or recommending executive and director compensation as well as the aggregate fees paid for all additional services;
- whether the decision to engage the compensation consultant or its affiliates for non-executive and non-director compensation services was made or recommended by management; and
- whether the board of directors or the compensation committee approved all other services in addition to executive and director compensation services.

Additional disclosure of fees is also required in situations where neither the board nor the compensation committee has engaged a compensation consultant, but management received executive and director compensation consulting services, as well as other compensation consulting services, and the fees from such other compensation consulting services exceeded $120,000 during the company's last completed fiscal year. Additional disclosures regarding arrangements with compensation consultants are not required, however, if the board and management have each utilized different compensation consultants and the board's consultant does not provide non-executive compensation consulting services to the company.

The new disclosure requirements would apply if the compensation consultant plays any role in determining or recommending the amount or form of executive and director compensation, other than the role limited to consulting on any broad-based plan available to all employees or providing information, such as surveys, that is either not

customized for a particular company or is customized based on parameters not developed by the compensation consultant, and about which the compensation consultant does not provide advice.

Reporting of Shareholders' Meeting Voting Results on Form 8-K

The rule amendments require the disclosure of the voting results of a shareholders' meeting under new Item 5.07 of Form 8-K within four business days after the end of the meeting at which the vote was held rather than in a Form 10-Q or Form 10-K.

If the matter subject to shareholder vote is one for which definitive voting results are not available within four business days after the meeting, the SEC has included an instruction that the company must disclose on Form 8-K the preliminary voting results within four business days after the preliminary voting results are determined, and must file an amended Form 8-K within four business days after final voting results are known. Companies concerned that disclosure of preliminary voting results could be confusing to investors may include additional disclosures to put the preliminary disclosure in the proper context.

Transition Guidelines

The SEC has provided the following guidelines related to the implementation of and transition to the new rules.

If the company's fiscal year ends on or after December 20, 2009, its Form 10-K and proxy statement must comply with the new requirements if filed on or after February 28, 2010. If such 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 rules discussed in this alert, even if filed before February 28, 2010. If such 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 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 disclosure requirements, even if filed on or after February 28, 2010. In addition, such company will not be required to comply with the new rules in its Securities Act or Exchange Act registration statements filed before its 2010 Form 10-K is required to be filed.

If a new registrant files its registration statement in connection with an initial public offering or registration under the Securities Exchange Act of 1934 on or after December 20, 2009, compliance with the new rules would be required for such registration statement in order for it to be declared effective on or after February 28, 2010.

If the annual meeting of shareholders takes place on or after February 28, 2010, but the proxy statement for the meeting was mailed to shareholders before that date, the results of the meeting are subject to reporting pursuant to Item 5.07 of Form 8-K. If the meeting takes place before February 28, 2010, disclosure under Item 5.07 of Form 8-K is not required.

Ten Important Steps to Take Now to Prepare for the 2010 Proxy Season

In light of the foregoing amendments, public companies may wish to consider taking the following actions:

- Update directors' and officers' questionnaire to incorporate the changes to Regulation S-K, including, among other things, the expanded disclosure requirements relating to other public company directorships and legal proceedings.
- Review with the board or the compensation committee the compensation policies and/or practices to determine whether any of those policies and practices present risks that are reasonably likely to have a material adverse effect on the company, and if so, discuss whether in addition to required disclosure, any changes to potential future incentive compensation awards should be made.
- Determine the company's "named executive officers" in light of the potential impact of the new grant date fair value reporting of equity awards.
- Recompute disclosure in equity awards columns for each preceding fiscal year presented in the Summary Compensation Table to comply with the new grant date fair value requirement for each "named executive officer" continued to be included in the compensation tables (the total compensation columns should be correspondingly recomputed).
- Develop a methodology or process to allow the board or nominating committee to track and explain the specific skills and qualifications of each director and nominee for director that were considered and reevaluation of the existing disclosure related to the specific

minimum qualifications and specific qualities or skills used by the board or nominating committee in the director nomination process.

- Adopt a board or nominating committee policy related to the consideration of diversity in identifying director nominees and consider how such policy should be implemented.
- Review the board's current leadership structure, and if one person serves as the principal executive officer and board chairman, consider appointing a lead independent director and define the role of such director in the leadership of the board.
- Review with the board and an appropriate board committee how the board administers its risk oversight function and the effect that it has on the board's leadership structure.
- Appropriately document all decisions made by the board and board committees in connection with the foregoing recommended action items.
- Review the services currently being provided and that were provided in the latest fiscal year to the company, the board or any board committee by compensation consultants and, if necessary, adopt or revise procedures to track the services provided by, and the fees paid to, the compensation consultants and their affiliates.

Questions

Any person who has a question regarding the issues raised in this *Corporate and Securities Update* may obtain additional guidance from a member of our Public Companies Group (www.blankrome.com). ■

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