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Weil Briefing:
SEC Disclosure and Corporate Governance

December 17, 2009

New Rules: SEC Approves Enhanced Compensation & Governance Disclosures for 2010 Proxy Season

Yesterday, the U.S. Securities and Exchange Commission approved measures that expand required disclosures in the areas of executive compensation and corporate governance, just in time for the 2010 proxy season. A copy of the SEC's adopting release is available at http://www.sec.gov/rules/final/2009/33-9089.pdf.

The effective date of the amendments is February 28, 2010. Therefore, proxy and information statements and Form 10-Ks and 8Ks, among others, filed on or after this date would need to comply. Because interpretive issues often arise following the release of new rules, we recommend that companies monitor SEC staff guidance during the following months.

The rule amendments focus on enhancing disclosure in the following areas:

- Director and Director Nominee Qualifications and Experience
- Other Directorships and Legal Proceedings
- Diversity Consideration in the Nomination Process
- Leadership Structure and Rationale
- Board Role in Risk Oversight
- Reporting of Voting Results
- Compensation Policies and Practices as Related to Risk Management
- Valuation of Equity Awards
- Fees Paid to Compensation Consultants and Potential Conflicts

The SEC's original July 2009 proposal included amendments regarding proxy solicitation procedures. However, in light of the interrelationship of those proposals to the SEC's separately pending proxy access proposal, the SEC has deferred action on these proposed amendments.[1]

Expansion of Disclosure Requirements Related to Governance

- **Director and Director Nominee Qualifications and Experience.** As amended, Item 401 of Regulation S-K expands the required disclosures to include, for each director and nominee, the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company. Previously, the rules only required disclosure of the minimum qualifications to be a nominee and brief biographical information.

  This new disclosure appears to require a justification, in some sense, of the board service of each nominee and continuing director (i.e., why was the person selected as a director?), and also, in respects, to get to what the board views as the "fit" between service and the board's needs.[2] The disclosure called for by these rules implies that there is an articulable set of factors underlying a person's nomination, even if different members of the nominating committee believe different factors are relevant to a particular candidate's nomination or weigh the factors differently. Note that, unchanged by the amendments, there continues to be a separate disclosure requirement in Item 407(c)(2)(v) of Regulation S-K regarding the specific minimum qualifications and specific qualities or skills required by the nominating committee for a nominee.

- ***Actions to Take***: The nominating committee, the board and the company will need to carefully consider how to articulate in annual disclosures the qualifications of each director and nominee. Disclosure requirements aside, we recommend that the nominating committee review annually with the board the composition of the board as a whole, including the balance of independence, business specialization, technical skills, diversity and other desired qualities that the directors bring to the board. Company counsel should begin a dialogue with the nominating committee chair early in each calendar year. As a starting point, the nominating committee chair and company counsel should consider requesting updated CVs from each of the directors (some companies may choose to include additional questions in the D&O questionnaire). Companies should begin drafting this section of the proxy statement early since each director will likely take a keen interest and may have comments.

- **Other Directorships & Legal Proceedings**. The amendments to Item 401 of Regulation S-K require disclosure of other directorships held by each director or nominee at any public company during the previous five years, rather than only current directorships. The amendments also extend from five to ten years the disclosure of legal proceedings involving directors, director nominees and executive officers. In addition, the range of legal proceedings now includes: (i) judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity; (ii) judicial or administrative proceedings based on the violation of the federal or state securities, commodities, banking or insurance laws or regulations or any settlement thereof; and (iii) any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization. Settlement of private litigation is not required to be disclosed. Such disclosures are intended to assist investors in evaluating the character and competence of directors.

    - ***Actions to Take:*** Company counsel should revise D&O questionnaires to reflect these changes.

- **Diversity Consideration in the Nomination Process**. As amended, Item 407(c) of Regulation S-K requires disclosure of whether and, if so, how the nominating committee 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 imposed a definition of "diversity."

   - ***Actions to Take:*** Companies may not be prepared adequately for this disclosure because it was not one of the July 2009 proposed amendments. Company counsel should bring this item to the attention of the board and work with the nominating committee to provide responsive disclosure.

- **Board Leadership Structure and Rationale.** As amended, Item 407 of Regulation S-K requires disclosure about the board's leadership structure and why the company believes it is the best structure for the company. Companies will have to disclose whether and why they have chosen to combine or separate the CEO and board chair positions. In circumstances where such positions are combined, the amendments require the company to disclose whether and why the company has a lead independent director and the specific role the lead independent director plays in the leadership of the company. As noted in the proposing release and reiterated by the SEC at its open meeting, these amendments are intended to provide greater transparency to investors, but are not intended to influence the company's decision about its board leadership structure.

   - ***Actions to Take:*** At companies having a combined CEO/Chairman, boards should review the justification for the combined position. Many companies have already publicly taken a position on this issue in response to shareholders' Rule 14a-8 proposals to separate these positions.

- **Board Role in Risk Oversight**. As amended, Item 407 of Regulation S-K requires disclosure about the board's role in the oversight of risk and the effect, if any, that this has had on the company's leadership structure. This requirement is intended to provide investors with an understanding of how the board administers its oversight function, such as through the entire board, a separate risk committee or the audit committee. In the adopting release, the SEC enumerated credit risk, liquidity risk, and operational risk as some of the risks that should be addressed. The SEC also suggested that, where relevant, companies may want to address whether the individuals who supervise the day-to-day 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.

   - ***Actions to Take:*** We recommend that companies consider what changes, if any, should be made to their risk management philosophies, policies and processes in light of the heightened scrutiny applicable to risk oversight.

- **Reporting of Voting Results**. The amendments transfer from Forms 10-Q and 10-K to a new item on Form 8-K (5.07) the disclosure of the results of a shareholder vote. Now, such disclosure will have to be made within four business days after the end of the meeting at which the vote was held. In response to concerns that voting results may not be available in time to meet the Form 8-K deadline, companies are instructed to file preliminary results within the four business day period and then file an amended Form 8-K within four business days after the final results are known. The SEC also clarified that if the company believes that preliminary results will not be indicative of the final results, the company may include additional disclosure to this effect in the Form 8-K.

- ***Actions to Take:*** Companies will need to add a new item to their annual meeting checklists and disclosure controls and procedures. In addition, companies and their investor relations personnel should be prepared to deal proactively with the media and investors following the release of voting results. For example, results announced shortly following a meeting likely trigger greater media interest (possibly instigated by activist investors) particularly when there has been substantial support in favor of a shareholder proposal or when there have been significant “withheld” or “against” votes cast on incumbent directors.

Expansion of Disclosure Requirements Related to Compensation

- **Compensation Policies and Practices as Related to Risk Management**. As amended, Item 402 of Regulation S-K will require narrative disclosure about the company’s compensation policies or practices for all employees generally, not just executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. In the adopting release, the SEC explained that companies are familiar with this disclosure threshold used in the Managements’ Discussion and Analysis (Item 303 of Regulation S-K), and that this approach should parallel the MD&A requirement, which requires risk-oriented disclosure of known trends and uncertainties that are material to the business. The adopted threshold is intended to elicit disclosure about compensation policies and practices that are most relevant to investors and generally assist investors in determining whether a company has established a system of incentives that can lead to excessive or inappropriate risk taking by employees. The SEC further noted that, in assessing whether disclosure is required, companies can take into account controls and other elements that may mitigate the probability or potential impact of compensation policies that might otherwise create risk.

  In response to comments that it would be potentially confusing to expand the Compensation Discussion & Analysis section of proxy statements to cover matters not involving named executive officers, the new disclosure requirement will *not* be a part of the CD&A.

  The adopting release provides a non-exhaustive list of situations that potentially could trigger discussion, as well as examples of issues that a company may need to address regarding its compensation policies and practices if the company determines that disclosure is required.

  Note that the final rule does *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 as originally proposed.

  - ***Actions to Take:*** These rules require additional disclosure analyzing the relationship between compensation policies and practices and company risk and will require a detailed risk assessment. We expect that a number of companies, unaccustomed to evaluating compensation from a risk management perspective, may need to seek advice from outside experts to address these matters critically.

- **Valuation of Equity Awards**. The reporting of stock and option awards in the Summary Compensation Table and Director Compensation Table will now require disclosure of the aggregate grant date fair value of awards made during the year to be computed in accordance with *Financial Accounting Standards Board Accounting Standard Codification Topic 718, Compensation – Stock Compensation* (formerly FAS 123(R)), rather than the dollar amount recognized for that year for financial statement reporting purposes.

A new instruction to the Summary Compensation Table, the Grants of Plan-Based Awards Table and the Director Compensation Table clarifies that for awards subject to performance conditions, the amount to be included in the table is the value at the grant date based on the *probable outcome* with respect to satisfaction of the performance condition, consistent with the recognition criteria in FASB ASC Topic 718 (excluding the effect of estimated forfeiture), not the maximum potential value of the award. The maximum potential value would be disclosed in a footnote to the Summary Compensation and Director Compensation tables. This change is intended to simplify the determination of the amounts to include in the tables and better reflect the compensation committee's decisions with regard to these awards.

The stock and option awards columns will only included amounts for awards with grant dates, as determined for financial accounting purposes, occurring during the year (the SEC rejected comments suggesting that disclosure be made of awards granted *for services* in the relevant fiscal year, even if granted after fiscal year end would be more informative). The adopting release included a reminder from the SEC that companies should continue to analyze in the CD&A their decisions to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of NEO compensation for the fiscal year per Instruction 2 to Item 402(b), and consider including supplemental tabular disclosure where it facilitates understanding the CD&A.

To facilitate year-to-year comparisons, companies providing Item 402 disclosure for a fiscal year ending on or after December 20, 2009, are required to present recomputed disclosure for each preceding fiscal year required to be included in the table, so that the stock awards and option awards columns present the applicable full grant date fair values, and the total compensation column is correspondingly recomputed. The stock and option awards columns amount should be recomputed based on the individual award grant date fair values reported in the applicable year's Grants of Plan-Based Awards Table, except that awards with performance conditions should be recomputed to report grant date fair value based on the probable outcome as of the grant date, consistent with FASB ASC Topic 718. In addition, the SEC explained in the adopting release 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 fiscal years must be reported. However, companies are *not* required to include different named executive officers for any preceding fiscal year based on the recomputed total compensation for those years.

- ***Actions to Take:*** The SEC's changes may impact which executive officers are identified as the named executive officers for proxy disclosure purposes and may cause the list of NEOs to change more frequently from year to year. Companies need to assess the effect of grant date fair value reporting of equity awards on the determination of the list of NEOs. To avoid surprises, companies should consider creating, sooner rather than later, a pro forma summary compensation table that reflects the new method of valuing equity awards.

- **Fees Paid to Compensation Consultants and Potential Conflicts**. New disclosures under Item 407(e) of Regulation S-K are required about fees paid to and services provided by compensation consultants and their affiliates if such consultants provide consulting services related to director or executive compensation and also provide other services to the company.

  If either the board or compensation committee *has* engaged its own consultant to provide advice or recommendations on the amount or form of executive or director compensation and this consultant or its affiliate provided other services to the company in an amount in excess of $120,000 during the company's last fiscal year, the company is required to disclose:

  - The aggregate fees paid for advising on the amount or form of executive and director compensation and the amount paid for all additional services;
  - Whether the decision to engage the consultant or its affiliates for such additional services to the company was made by or recommended by management; and
  - Whether the board or compensation committee approved the other services provided to the company.

  If the board or compensation committee *has not* engaged its own compensation consultant, but a consultant provided executive compensation consulting services to the company that also provided other services to the company in an amount in excess of $120,000, the company is required to disclose the aggregate fees paid for advising on the amount or form of executive and director compensation and for all additional services.

  Disclosure for fees paid to other compensation consultants retained by the company is not required if the board has retained its own consultant that reports to the board. The SEC also adopted exceptions where (i) the compensation consultant's only role in determining the amount of executive compensation is in connection with consulting on broad-based plans that do not discriminate in favor of executive officers or directors, or (ii) the consultant's services are limited to providing non-customized information to the company such as surveys.[3]

  - ***Actions to Take:*** Companies should review the services provided by compensation consultants and the company's existing policies and practices regarding the retention of compensation consultants. Companies will need to update their disclosure controls and procedures for the forthcoming change. In any event, best practices dictate that the compensation committee be aware of and approve of all services to the company provided by consultants on whose advice they rely.

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

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[1] See Release No. 33-9046 (June 10, 2009). On December 15, 2009, the SEC announced that it reopened the comment period on its proxy access proposal for 30 days after the publication of the SEC release in the Federal Register. The SEC sought comment specifically on four studies that had been submitted towards the end of the comment period. A copy of the SEC's release is available at http://www.sec.gov.

[2] Directors and nominees may be concerned that the disclosure of certain experience and capabilities (e.g., expertise as an investment banker) may inappropriately suggest that such person bears greater responsibility for certain decisions than other board members due to his or her expertise in a particular area, and therefore is subject to a higher degree of liability. A similar concern was raised in 2002 when the SEC proposed rules requiring disclosure of the name of a company's audit committee financial expert (if any). In that case, the SEC addressed this issue by stating that such identification does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and the board of directors in the absence of such designation or identification. The new rules do not include such a safe harbor but no negative implication of greater responsibility appears to have been intended.

[3] Our December 11, 2009 Briefing relating to pending House and Senate bills on compensation committees' retention of outside compensation consultants is available at http://www.weil.com/files/upload/Weil_Briefing_Corp_Gov_2009_Dec_14_.pdf.