AKIN GUMP
STRAUSS HAUER & FELD LLP

December 22, 2009

CORPORATE ALERT

SEC ADOPTS CHANGES TO EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE DISCLOSURE RULES

On December 16, 2009, the Securities and Exchange Commission (SEC) adopted amendments to its disclosure rules that will require public companies to provide enhanced proxy and information statement disclosure about certain executive compensation and corporate governance matters.[1] Specifically, the rule changes—

- require that stock awards and option awards granted to executives and directors be reported at grant date fair value, rather than the value recognized for the fiscal year for financial reporting purposes
- require discussion of how a company's compensation policies and practices for employees affect the company's risk and management of risk if the risks arising from such policies and practices are reasonably likely to have a material adverse effect on the company
- require discussion of the board of directors' role in risk oversight
- require disclosure of the company's leadership structure (such as whether it separates or combines the CEO and chairman of the board positions) and the reason(s) the company has chosen its particular leadership format
- require disclosure of the specific qualifications and attributes of directors and nominees for director that qualify them to serve on the board and the role, if any, diversity plays in the selection of nominees
- expand the disclosure about directors and nominees to include any directorships held by them in the past five years, not just those currently held
- lengthen the time period for disclosing certain legal proceedings involving directors, nominees and executive officers from the past five years to the past 10 years and expand the types of legal proceedings for which disclosure is required
- require disclosure, in certain circumstances, of fees paid to compensation consultants if they played a role in determining or recommending the amount or form of executive or director compensation and also provided more than $120,000 of additional services to the company.

[1] SEC Rel. Nos. 33-9089, 34-61175, Proxy Disclosure Enhancements (December 16, 2009).

The rule changes also require that results of shareholder votes be reported within four business days on Form 8-K (rather than quarterly on Form 10-Q).

In the proposing release regarding the rule changes, the SEC had also proposed changes to its proxy solicitation rules to codify certain SEC staff positions. The SEC deferred actions on these matters until 2010, when it takes up final consideration of its proxy access proposal.

The rule changes will become effective on February 28, 2010, and, therefore, will apply to the 2010 proxy season. It is not entirely clear, however, how the transition to the new rules will be made. For example, if a company files a preliminary proxy statement prior to February 28, 2010, but does not intend to file the definitive proxy statement until after the effective date, it is not clear whether the company should comply with the old rules or the new rules. Presumably, the SEC will provide further guidance on how companies transition to the new rules.

CHANGES TO EXECUTIVE COMPENSATION DISCLOSURE

Stock and Option Awards. The amendments to Item 402 of Regulation S-K require companies to report the value of stock and option awards in the Summary Compensation Table and the Director Compensation Table, based on the aggregate grant date fair value of such awards as computed in accordance with FASB ASC Topic 718 (formally referred to as FAS 123R), rather than the dollar amount recognized for financial reporting purposes for the fiscal year. The SEC believes that reporting the full grant date fair value better reflects the compensation committee's decision with regard to stock and option awards and will provide clearer, more meaningful disclosure of the compensation awarded to executives.

Because performance awards typically are designed to incentivize attainment of target performance, the rules clarify that the value of performance awards reported in the tables should be computed based upon the probable outcome of the performance condition as of the grant date and that this amount should be consistent with the grant date estimate of compensation cost to be recognized over the service period as determined under FASB ASC Topic 718, excluding the effect of estimated forfeitures. The SEC believes that basing the value on the probable outcome rather than on maximum performance better reflects how compensation committees take performance-contingent vesting conditions into account when granting awards. To ensure that investors understand the maximum potential value of the award, the rules do, however, require companies to disclose this value in a footnote.

Consistent with the prior rules, the amended rules require companies to report the aggregate grant date fair value of stock and option awards granted during the relevant fiscal year, even if they are granted for services performed in a prior year. The SEC had solicited comment on whether awards should be reported based on the aggregate grant date fair value of awards granted for services performed during the relevant fiscal year even if the awards were granted after fiscal year end. The SEC did state in the adopting release, however, that if a company does grant post-fiscal year-end equity awards that relate to services provided in a prior year, it should consider providing analysis on such decisions in its Compensation Discussion and Analysis.

The new rule changes for reporting equity awards are effective for disclosures relating to fiscal years ending on or after December 20, 2009. The rule changes may significantly alter the total compensation reported for executive officers and, therefore, may result in a change in the composition of a company's named executive officers for 2009. In transitioning to the new rule, companies are required to present in their 2010 proxy statements recomputed disclosure for 2008 and 2007, reflecting full grant date fair values of stock and option awards and corresponding adjustments to total compensation. If a person who would be a named executive officer for 2009 was also disclosed as a named executive officer for 2007 but not for 2008, the officer's compensation should be reported for each of the three years. Companies are not, however, required to include different named executive officers for any preceding fiscal year based on the recomputation.

The SEC ultimately decided not to adopt proposed rules that would have: (1) rescinded 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 disclosure in the Director Compensation Table and (2) changed the reporting obligations relating to salary or bonus forgone at a named executive officer's election. As such, the reporting obligations for these situations have not changed.

Risk Management Disclosure. Under the new rules, companies must include in their proxy statements a discussion and analysis of how a company's policies and practices of compensating its employees create incentives that can affect the company's risk and management of risk, if the risks arising from such policies and practices are reasonably likely to have a material adverse effect on the company. To the extent the risks arising from such compensation policies and practices are not reasonably likely to have a material adverse effect on the company, no disclosure is required.

The final rules contain several important changes from the rules as initially proposed. First, the new disclosure will not appear as part of Compensation Discussion and Analysis as had been originally proposed[2]. Second, the rule has been clarified to provide that disclosure is required only if the risks that result are "adverse" risks. Third, the threshold for triggering disclosure has been changed to a "reasonably likely" standard, in contrast to the initially proposed threshold that would have required disclosure if the risks "may" have a material effect on the company. The SEC noted that companies are already familiar with the "reasonably likely" disclosure threshold, used in Management's Discussion and Analysis, that requires risk-oriented disclosure of known trends and uncertainties that are material to the company. By changing to the higher standard, the SEC seeks to avoid disclosure of potentially insignificant and speculative information about compensation policies. Furthermore, the change to the higher threshold allows policies and practices a company may have for different groups of employees that mitigate or balance incentives to be considered in deciding whether the risks from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company.

While the SEC acknowledges that the situations requiring disclosure will vary, the SEC lists several situations that may trigger the new disclosure, including 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 business units that are significantly more profitable than others within the company
- at business units where the compensation expense is a significant percentage of the unit's revenues
- 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.

[2] Nevertheless, a discussion of risk may be required in Compensation Discussion and Analysis regarding named executive officers. In both the adopting and proposing releases, the SEC stated that, under existing rules, companies should include in their Compensation Discussion and Analysis a discussion of risk considerations if they are a material aspect of the company's compensation policies and practices for named executive officers.

Emphasizing that the purpose of the new disclosure requirement is to provide investors with material information concerning how a company compensates and incentivizes its employees in ways that may create risks reasonably likely to have a material adverse effect on the company, the SEC provides the following examples of issues that a company may need to address—

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

Smaller reporting companies are not required to provide the new disclosure, as the SEC believes that such companies are less likely to have the types of compensation policies and practices intended to be addressed by the new rules.

If a company determines that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company, the company is not required to make an affirmative statement to that effect in its proxy statement.

Compensation Consultants. The amendments to Item 407 of Regulation S-K will require companies to disclose, in certain circumstances, fees paid to compensation consultants that played a role in determining or recommending the amount or form of executive or director compensation if they provided more than $120,000 of additional services to the company during the company's last fiscal year. These changes stem from concerns that fees paid to compensation consultants for providing additional services, such as benefits administration, human resources consulting or actuarial services, could create a conflict that calls into question the objectivity of the consultant's executive compensation advice and recommendations, particularly if fees generated by these additional services are significant.

The final rules address these concerns as follows—

- If the board or compensation committee engaged a compensation consultant to provide executive compensation advice or recommendations, and the consultant or its affiliates provided additional services to the company or its affiliates in excess of $120,000 during the company's last fiscal year, the company must disclose—
  - the aggregate fees paid for determining or recommending the amount or form of executive and director compensation and the aggregate fees paid for the additional services
  - whether the decision to engage the consultant or its affiliates for these additional services was made, or recommended by, management

- whether the board or compensation committee approved such additional services.

- If the board or compensation committee did not engage a compensation consultant, but management did engage a consultant to provide executive or director compensation advice or recommendations, and the consultant or its affiliates provided additional services to the company in excess of the $120,000 threshold, the company must disclose the aggregate fees paid for the executive and director compensation advice and the aggregate fees paid for the additional services.

The SEC noted that certain services are not likely to raise conflicts of interest concerns. Therefore, no disclosure is required if the compensation consultant's only role in recommending the amount or form of executive or director compensation is limited to: (1) consulting on any broad-based plans, such as 401(k) plans or health insurance plans, that do not discriminate in favor of a company's executive officers or directors and are available generally to all salaried employees or (2) providing information, such as a survey, that either is not customized for the company or is customized based on parameters that the consultant did not develop and about which the consultant did not provide advice.

The final rules do not require companies to describe the nature and extent of any additional services provided to the company by the consultant. Although the proposed rules would have required this disclosure, concerns were raised that such disclosures could cause competitive harm by revealing confidential and sensitive pricing information. Companies may, at their discretion, describe these additional services provided by the consultant if such information would facilitate an investor's understanding of the existence or nature of any potential conflicts of interest.

CHANGES TO CORPORATE GOVERNANCE DISCLOSURES

Director and Nominee Qualifications. Item 401 of Regulation S-K has been amended to expand the disclosure requirements regarding directors and nominees. Specifically, companies must disclose for each director and nominee for director the particular experience, qualifications, attributes or skills that led the board to conclude that, in light of the company's business and structure, the person should serve as a director of the company as of the time that the filing containing such disclosure is made with the SEC. This provision is aimed at helping investors determine whether a particular director and the entire board composition are appropriate choices for a given company. The new rules do not specify the particular information that should be disclosed, and unlike the proposed rules, the final rules do not require disclosure of why a person is qualified to serve on any board committees.

Diversity. Under amended Regulation S-K Item 407(c), companies must disclose whether—and if so, how—the nominating committee considers diversity in identifying nominees for director. If the nominating committee or board has a diversity policy, the company must disclose how the policy is implemented and how the nominating committee or board assesses its effectiveness.

The new rule does not contain a definition of "diversity." In the adopting release, the SEC stated that companies may define diversity in different ways, noting that some companies view diversity expansively to include differences of viewpoint, professional experience, education, skills and other qualities and attributes that contribute to board heterogeneity, while other companies may view diversity in terms of race, gender and national origin.

Public Company Directorships. Under the new rules, companies must disclose any public company directorships[3] held by each director and nominee at any time within the past five years. Prior to the amendment, Item 401 of Regulation S-K required disclosure only of presently held directorships.

[3] Specifically, any directorship held at any company with a class of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 or subject to the requirements of Section 15(d) of that act, or any company registered as an investment company under the Investment Company Act.

Legal Proceedings. Amended Item 401 lengthens, from five to 10 years, the period of time for which disclosure of specified legal proceedings involving any director, executive officer or nominee for director is required, and also expands the type of proceedings for which disclosure is required to include—

- 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 and regulations, or any settlement[4] to such actions
- any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Board Leadership Structure. Under amended Item 407 of Regulation S-K, companies must disclose their leadership structure, including whether the company separates or combines the positions of principal executive officer and chairman of the board. If one person serves in both capacities, the company must disclose whether it has a lead independent director and the specific role the lead independent director plays in the board's leadership. The company must also explain why it has determined that its leadership structure is appropriate given the company's specific characteristics or circumstances.

Board's Role in Risk Oversight. Amended Item 407 of Regulation S-K requires disclosure of the extent of the board's role in risk oversight and the effect that this has on the company's leadership structure. In view of the role that risk and the adequacy of risk oversight played in the recent market crisis, the SEC believes it is important for investors to understand the board's role in this area. Companies are expected to discuss how the board implements and manages its risk oversight function, such as through the board as a whole or through a committee, e.g., the audit committee.[5] The disclosure might address matters such as whether the persons who oversee risk management 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.

Shareholder Voting Results. Shareholder voting results must be reported under a new Item 5.07 to Form 8-K, which must be filed within four business days after the meeting at which the vote was taken.[6] The requirement of reporting shareholder voting results on the Form 10-Q or Form 10-K (for the fourth quarter) for the quarterly period in which the shareholder meeting took place, has been deleted. Under the new rules, companies are required to file a Form 8-K disclosing the preliminary voting results within four business days after the date of the shareholder meeting and file an amended report on Form 8-K within four business days after the final voting results are known.[7]

[4] This does not include disclosure of a settlement of a civil proceeding among private parties.

[5] Section 303A of the NYSE's Listed Company Manual provides that the audit committee of companies listed on the exchange must "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken."

[6] The four-business-day period will begin to run on the day on which the meeting ended. Similar disclosures on Form 8-K will be required when a matter is submitted to a vote of security holders otherwise than at a meeting, such as by written consent.

[7] If final results are known before the initial Form 8-K is filed, the company can simply file one Form 8-K reporting the final results.

PROXY SOLICITATION MATTERS DEFERRED

In addition to the changes to the disclosure rules relating to executive compensation and corporate governance, the SEC had also proposed to amend its proxy solicitation rules to codify several SEC staff positions. The SEC announced that it is deferring a decision on these matters pending consideration of its proxy access proposal. Among other things, the proposed changes to the proxy solicitation rules would allow persons to provide shareholders an unmarked copy of management's proxy card to be returned directly to management without having to conduct a fully regulated proxy solicitation. This would facilitate "just vote no" campaigns, since shareholders would be able to change their votes without having to request another proxy card from management. Another proposed change would codify an SEC staff position allowing a dissident in a proxy contest to round out a short slate with candidates proposed by another insurgent group.

WHAT COMPANIES SHOULD BE DOING NOW

The rule amendments will become effective February 28, 2010. Consequently, companies should begin immediately to address the rule changes. Among other things, companies should be addressing the following—

- *D&O Questionnaires*. Director and officer questionnaires should be revised or supplemented to reflect the required new disclosures concerning the 10-year lookback for certain legal proceedings, the expansion of the types of legal proceedings for which disclosure is required, any directorships held during the past five years and qualifications, experience and skills of directors.

- *Potential Changes to Named Executive Officers*. The change in the method of reporting the value of stock and option awards could significantly alter the total compensation reported for executive officers and, therefore, could affect which officers are identified as named executive officers in a company's proxy statement.

- *Risk Oversight and the Board*. In light of the additional disclosures required concerning the board's role in risk management oversight, the board of directors should evaluate the adequacy of its risk management oversight procedures. For a more detailed discussion of this topic, see our alert, "Top 10 Topics for Directors in 2010," which is available here.

- *Risk Management and Compensation*. The compensation committee should review the company's compensation policies for all employees to determine whether the risks arising from those policies are reasonably likely to have a material adverse effect on the company, and, if so, whether any actions should be taken to mitigate or manage those risks. Because the compensation committee may not be involved in oversight of the design and administration of compensation programs for employees generally, the committee will need to devote additional time and attention to understanding these broader-based plans and assessing their risks.

- *Board Composition and Leadership Structure*. In light of the new disclosure requirements regarding director qualifications, the nominating committee should review the board's composition to determine whether it has the appropriate mix of experience and skills to address the company's business needs and challenges. Company counsel will need to work closely with the nominating committee to draft the required disclosure about why the board believes that each incumbent director and nominee is a good fit for the company and to allow sufficient time for each director to review the planned disclosures. The board should also reassess its leadership structure to determine whether the structure is appropriate for the company. The nominating committee or board should also address the extent to which diversity does, or should, play a role in determining board makeup, and how diversity is defined. Our client alert, referenced above, on "Top 10 Topics for Directors in 2010" discusses these topics in more detail.

- *Compensation Consultants*. In light of the additional disclosures concerning compensation consultants when they provide additional services to a company, the board or compensation committee should review the manner in which the company uses compensation consultants. Over the past few years, the use by compensation committees of pay consultants who perform other work for the company has drawn increasing fire from institutional investors and shareholder activists concerned about potential conflicts of interest.

CONTACT INFORMATION

If you have questions concerning this alert, please contact—

Jessica Cherry	jcherry@akingump.com	212.872.7437	New York
Gemma L. Descoteaux	gdescoteaux@akingump.com	214.969.4783	Dallas
Julie M. Kaufer	jkaufer@akingump.com	310.728.3313	Los Angeles
Christine B. LaFollette	clafollette@akingump.com	713.220.5896	Houston
Robin M. Schachter	rschachter@akingump.com	310.728.3363	Los Angeles
Lucas F. Torres	ltorres@akingump.com	212.872.1016	New York
Samuel Wolf	swolff@akingump.com	202.887.4462	Washington D.C.