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SEC Publishes Proposed Amendments to Executive Compensation and Corporate Governance Disclosure

The Securities and Exchange Commission recently published proposed amendments to the proxy rules that would require additional disclosures regarding executive compensation and corporate governance matters, including:

- the relationship of a company's overall compensation practices to risk management;
- the independence of compensation consultants;
- director and nominee experience and qualifications;
- board leadership structure (particularly with respect to the combination or separation of the CEO and Chairman positions); and
- the board's role in the company's risk management process.[1]

The proposed rules also would require the reporting of stock and option awards at grant date fair value, accelerate the disclosure of shareholder voting results and clarify aspects of the proxy solicitation rules.[2]

Comments on the proposed rules are due September 15, 2009. The SEC anticipates that the proposed rules, if adopted, would be effective for the 2010 proxy season.

Current Action Items

If, in fact, final rules are effective for the 2010 proxy season, it is likely that many companies will not have much time between the adoption of final rules and the time they start their annual proxy statement drafting process. Accordingly, companies and their boards of directors (or the appropriate board committees) should begin the process of considering their current policies and practices, in light of the anticipated additional disclosure requirements, to determine what new policies or modifications to existing policies, if any, would be desirable. For example, over the coming months, companies should:

- Review overall compensation policies and practices to determine whether risky behavior by employees is unduly incentivized and, if so, consider changes in compensation practices or risk management measures. This may involve:
  - reviewing compensation policies and practices for employees across the enterprise, with particular attention paid to variations across management levels and business units;

1 The SEC approved the proposal at its July 1, 2009 meeting and issued a summary at that time. That summary, together with SEC actions on "say on pay" for TARP recipients and elimination of broker discretionary voting in director elections, is described in a previous Skadden client memorandum dated July 7, 2009.

2 The proposed rules are set forth in SEC Release Nos. 33-9052, 34-60280, which is available at http://www.sec.gov/rules/proposed/2009/33-9052.pdf.

- reviewing risk assessments previously conducted (whether for compensation or other purposes) and risk management measures in place, in each case, to the extent relevant to compensation matters; and

- considering whether incentive compensation awards anticipated to be made in 2010 should be modified or other measures taken as a result of the analysis.

- Review the services currently provided to the company by any compensation consultants and the company's existing policies and practices regarding the retention of compensation consultants. Based on the review, consideration should be given to adopting or revising written policies regarding compensation consultant independence.

- Consider the need for additional procedures to enhance the company's ability to articulate the skills and qualifications of directors and nominees in the proxy statement.

- Confirm the board's belief that its current leadership structure is appropriate and consider the disclosure to be made in connection with that judgment.

- If the board has a lead independent director, consider the responsibilities associated with that position, whether such responsibilities should be formally articulated (in a company's corporate governance guidelines, for example) or whether any existing written description of the position should be revised.

- Review the role of the board and its committees (in many cases, the audit committee) in overseeing risk management and consider whether any changes are appropriate.

A summary of the proposed rules follows.

Executive Compensation

Relationship of Compensation Practices to Risk Management

The SEC notes that critics have suggested that compensation policies and practices at some companies are not sufficiently aligned with the long-term performance of the company and may have created compensation-driven incentives for management and employees to make decisions that significantly and inappropriately increase the company's exposure to risk. To address these concerns, the SEC proposes to expand Compensation Discussion and Analysis ("CD&A") to require disclosure about how a company's overall compensation policies and actual compensation practices for employees generally (not limited to "named executive officers") may create incentives for risk-taking behavior and impact risk management practices. Disclosure would be required to the extent that risks arising from compensation policies or practices "may have" a material effect on the company.

The proposed amendment to CD&A provides examples of situations that have the potential to trigger discussion and analysis:

- a business unit carries a significant portion of the company's risk profile;

- a business unit has a compensation structure significantly different from other company business units;

- a business unit is significantly more profitable than other company business units;

- a business unit's compensation expense is a significant percentage of the business unit's revenues; and

- a business unit's particular compensation policies and practices 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 extends over a significantly longer period of time.

The proposed amendment to CD&A also provides examples of the issues that may need to be discussed and analyzed, including the general design philosophy of the company's compensation policies, the company's risk assessment or incentive considerations in structuring compensation policies or in awarding and paying compensation, the adoption of measures such as claw back policies or imposing holding periods, and 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.

Stock and Option Awards

The rules relating to the Summary Compensation Table (and Director Compensation Table) were overhauled in August 2006 to require, among other things, that stock and option awards be disclosed based on the aggregate fair value of the awards (computed in accordance with FAS 123R) as of their respective grant dates. In December 2006, these rules were further amended to require disclosure of the dollar amount recognized for the fiscal year for financial reporting purposes — meaning that an award made in one year might be reflected in the compensation tables for a number of different years. The proposed rules would revert to disclosing stock and option awards in terms of aggregate grant date fair value. The SEC believes that this measure will better enable investors to evaluate the compensation decisions actually made during the year with respect to equity compensation. One impact of this change would be increased transparency for the incremental value of repricing options.

In addition, the proposed rules would:

- rescind the separate 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) as this information would be duplicative of information in the Summary Compensation Table (and Director Compensation Table); and

- provide that salary or bonus that the executive elected to forgo in favor of equity-based or other non-cash awards would be reported in the column pertaining to the award elected rather than included in the salary and bonus columns of the Summary Compensation Table.

The SEC notes that it is considering requiring companies to recompute the Summary Compensation Table disclosure for each of the prior reported years so that stock and option awards and total compensation would reflect the proposed changes and remain comparable year-to-year.

Independence of Compensation Consultants

The services provided to companies by compensation consultants, or their affiliates, are often not limited to recommendations regarding executive compensation plans or policies and may include additional services with significant fees, such as benefits administration, human resources and actuarial services. A December 2007 report by the U.S. House of Representatives Committee on Oversight and Government Reform reviewed data from companies in the Fortune 250 and concluded that many consulting firms earned fees for other services that far exceeded their fees for advising on compensation matters. The SEC believes that such additional services and fees may create the appearance of a conflict of interest and call into question the objectivity of the consultants' recommendations regarding executive compensation. Accordingly, if the company's compensation consultants play any role in determining or recommending the amount or form of executive or director compensation and the consultants or their affiliates provide any other services to the company, the proposed rules would require the following disclosure in the proxy statement:

- a description of the nature and scope of these additional services;
- the aggregate fees paid for executive and director compensation consulting and the aggregate fees paid for all other services;
- whether the decision to engage the compensation consultant for these other services was made, recommended or reviewed by management; and
- whether the board or the compensation committee approved the additional engagements.

Corporate Governance

Director and Nominee Experience and Qualifications

The proposed rules would require enhanced disclosure regarding the specific experience, qualifications, attributes or skills of each director and director nominee (whether nominated by the board of directors or another proponent) that qualify such person, in light of the company's business and structure, to serve as a director and as a member of any board committee on which the person serves.

The proposing release notes that the types of information that may be disclosed include, for example, information about a director's or nominee's risk assessment skills and specific past experience or particular expertise that would be useful to the company, and also might include a discussion of why the director's or nominee's service as a director would benefit the company.

In addition, disclosure of a director's or nominee's public company directorships would be expanded to include those held at any time during the past five years, rather than disclosing only current directorships. Also, the "look back" period for disclosing legal proceedings involving a director would be increased to 10 years, from the current five years. In addition, the SEC raised the question of whether the rules should be amended to require additional disclosure related to board diversity.

Board Leadership Structure

To provide greater transparency regarding the leadership structure of the board and how the board functions, the proposed rules would require the following additional disclosures:

- a brief description of the board leadership structure, including whether the company has chosen to combine or separate the Chairman and CEO positions, and the company's reasons for those decisions; and

- for a company that has combined the Chairman and CEO positions, whether the company has a lead independent director and the specific role the lead independent director plays in the leadership of the company.

The proposed rules also would require disclosure regarding the extent of the board's role in the company's risk management process and the effect that this has on the company's leadership structure. The proposing release notes that such disclosure might address, for example:

- whether the board implements its risk management function through the board as a whole or through a board committee;

- whether persons who oversee risk management report directly to the board as a whole or to a board committee; and

- whether and how the board or a board committee monitors risk.

Shareholder Voting Results

To make the disclosure of shareholder voting results more timely, the proposed amendments would transfer the disclosure requirement for such results from the Form 10-Q or Form 10-K covering the quarterly period in which the shareholder meeting was held (which can cause voting results to be disclosed several months after the meeting) to a new Item 5.07 of Form 8-K, which would need to be filed within four business days after the shareholder meeting.

In situations involving contested elections, where definitive voting results may not be available within four business days of the meeting, companies would be required to disclose preliminary voting results on Form 8-K within four business days after such preliminary results are determined and file an amended Form 8-K within four business days after final voting results are certified.

Proxy Solicitation Process

The proposed rules would codify a number of positions taken by the Staff of the SEC regarding the proxy solicitation process. Among other things, the proposed rules would:

- aid the efforts of persons relying on the "disinterested person" exemption under Rule 14a-2(b)(1) (when the soliciting person does not seek proxy authority) — sometimes relied on in "just vote no" campaigns, in efforts to oppose mergers and in support of Rule 14a-8 shareholder proposals — by clarifying that the exemption remains available when the person provides shareholders with an

unmarked copy of management's proxy card and requests that it be returned directly to management (effectively overturning a 2004 Second Circuit decision that the exemption from the proxy rules was not available under those circumstances); and

- codify the Staff's recent no-action position with respect to Amylin Pharmaceuticals that permitted two unrelated activist investors conducting simultaneous proxy contests for a short slate of nominees to "round out" their respective slates on their proxy cards — that is, solicit proxies to vote for the full number of directors to be elected — with nominees put forth by the other activist investor.