

SEC Proposes Rules to Enhance Compensation Decision-Making Transparency: Increased Disclosure Requirements for the 2010 Proxy Season and Certain Securities Filings

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This article describes the Securities and Exchange Commission published proposed rules that, if adopted as proposed, will significantly change public companies' required disclosures in their proxy statements and certain other filings.

On July 10, 2009, the Securities and Exchange Commission ("SEC") published proposed rules that, if adopted as proposed, will significantly change public companies' required disclosures in their proxy statements and certain other filings ("Proposed Rules").¹ The Proposed Rules, among other things, would increase compensation practice disclosure to cover non-executive employees; change the manner in which stock and option awards are reported; increase the discussion of the relationship between compensation policies and risk; and increase required information relating to compensation consultants' fees and services.² This article briefly describes the Proposed Rules which, if adopted as proposed, would require public companies

to make new and expanded disclosures in their next proxy statement.³

The Proposed Rules have been released in the midst of a financial crisis that has generated increased demand from investors, regulators and Congress for more transparent discussions of compensation practices at both the executive and non-executive levels. Although the Proposed Rules are subject to a 60-day public comment period, it is expected that the Proposed Rules will be finalized this year. Currently, the Proposed Rules are intended to apply to the 2010 proxy season, which means that reporting companies must have the information to make these new disclosures for 2009.

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THE PROPOSED RULES

Disclosure of Companies' Overall Compensation and Incentivization Policies and their Potential for Risk Creation

The Proposed Rules require companies to disclose their overall actual compensation policies for all employees where risks generated by those policies are considered material. Specifically, companies will be required to discuss compensation arrangements that could incentivize employees, whether or not executive officers, to take on excessive amounts of risk. In breaking with previous disclosure requirements, the Proposed Rules pertaining to risk disclosure would specifically extend the requirement beyond executive officers. The Proposed Rules outline a non-exhaustive list of particular situations that may require this type of disclosure, but emphasize that those situations requiring disclosure will vary by company and even individual compensation arrangement. The non-exhaustive list of situations that could trigger disclosure includes compensation policies:

- 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 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, 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.

In addition to identifying practices or compensation arrangements that would trigger disclosure, the Proposed Rules set forth a non-exhaustive list of the types of analysis and information that may be appropriate in disclosing such compensation arrangements. Specifically, the non-exhaustive list includes:

- The general design philosophy of the company's compensation policies for employees whose behavior would be most impacted by the incentives established by the policies, as such policies relate to or affect risk taking by employees on behalf of the company, and the manner of its implementation;
- The company's risk assessment or incentive considerations, if any, in structuring compensation policies or in awarding and paying compensation;
- How the company's 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 risk profile; 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.

Both in determining whether a particular compensation practice requires disclosure and in determining the level of detail and analysis required once disclosure is deemed appropriate, the Proposed Rule emphasizes that it will be a company-by-company and even a policy-by-policy determination. Disclosure is required only where risks related to compensation practices generally may have a material effect on the company, and disclosure can be further reduced in certain instances to protect trade secrets or confidential information. Companies should review their own policies and work with counsel to determine which, if any, of their compensation policies or programs create excessive or inappropriate risks that generally may have a material effect on their respective company, and therefore, require disclosure and analysis in those SEC filings covered by the Proposed Rules.

In their current form, the Proposed Rules would significantly expand public companies' compensation related disclosures.

CHANGES TO VALUATION OF STOCK AND OPTION AWARDS IN THE SUMMARY COMPENSATION TABLE AND DIRECTOR COMPENSATION TABLE

The Proposed Rules require that the aggregate grant date fair value be computed in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standard No. 123 ("FAS 123R"). This change would return to that valuation method used when the rules were initially adopted in 2006, but which was subsequently changed to the current valuation method (i.e., the dollar amount recognized for financial statement reporting purposes during the covered fiscal year) prior to the 2006 amendments becoming effective. Furthermore, the instructions to the Proposed Rules mandate that the summary compensation table and/or director compensation table include the incremental fair value (computed as of the date of repricing or modification) if the company has "repriced" options or stock ap-

preciation rights, whether through amendment, cancellation and replacement grants or any other means, or which have otherwise materially modified such awards in the last completed fiscal year. For those companies that do not believe that full grant date fair value provides an adequate picture of an executive officer's compensation, they can explain the inadequacy in a narrative disclosure.

In the explanatory notes to the Proposed Rules, the SEC indicated that using this new measure allows investors to evaluate better the total equity compensation awarded by disclosing the full value of each award on the grant date. One possible effect of this change to valuation methods may be to change who a given company's named executive officers are, due to the different amounts that may need to be included for SEC reporting purposes in certain individuals' total compensation.⁴

INCREASED DISCLOSURE OF COMPENSATION CONSULTANTS' FEES AND SERVICES

The Proposed Rules add new requirements to disclose compensation fees of consultants, including their affiliates, and descriptions of the non-compensation related services that compensation consultants provide. Currently, companies are not required to disclose fees paid to compensation consultants, nor are they required to describe the non-compensation services that these consultants provide.⁵ By requiring these additional disclosures, the SEC believes that investors will be better able to evaluate compensation decisions made by boards of directors. If adopted in current form, the Proposed Rules would require that where a compensation consultant, including its affiliates, played a role in determining or recommending the amount or form of executive or director compensation and also provided additional services⁶ to the company then the company must disclose:

- The nature and the extent of all additional services provided;
- The aggregate fees for determining or recommending the amount or form of executive and director compensation;

- The aggregate fees for such additional services;
- Whether the decision to engage the compensation consultant or their affiliates for these other services was made, subject to screening, or recommended, by management; and
- Whether the compensation committee or the board approved such other services of the compensation consultants or their affiliates.

These new requirements would be in addition to, not in lieu of, existing required disclosures. The new requirements would also put in place a new exception to when disclosure is required; that companies need not make any disclosure regarding a compensation consultant where the consultant's role is limited to consulting on a broad-based plan or plans that do not discriminate in favor of executive officers or directors, and that are available to all salaried employees.

CONCLUSION

In their current form, the Proposed Rules would significantly expand public companies' compensation related disclosures. While the Proposed Rules could undergo changes before being adopted, it is likely that the major components of the proposals will be adopted in time to be applicable to the 2010 proxy season. Consequently, public companies may wish to review their policies and procedures, especially those involving risk management, as well as their internal control over financial reporting to ascertain the scope and nature of the changes that will be required to comply with these changes, which, if adopted as proposed, will apply to the current year, 2009, rather than prospectively.

NOTES

¹ See SEC Release No. 33-9052 (Proposed Rules published on July 10, 2009), available at www.sec.gov/rules/proposed/2009/33-9052.pdf. The Proposed Rules also cover additional items unrelated to compensation disclosures. This article focuses only on those parts of the Proposal specifically related to compensation disclosure. The non-compensation portion of the Proposed Rules, if

adopted, would: (i) expand the disclosure requirements for qualifications of directors and director nominees; (ii) require disclosure of companies' independent board leadership structure and an analysis of why that structure fits the particular company; (iii) transfer disclosure of voting results to Form 8-K; and (iv) amend the proxy rules to clarify their operation and facilitate shareholder communication and voting among other things.

² The Proposed Rules amend several SEC rules and regulations, most importantly, Item 402 of Regulation S-K—Standard Instructions for Filing Forms Under the Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975 (17 C.F.R. 229.402)(Item 402 of Reg. S-K). The current rules regarding executive compensation disclosure required in annual proxy statements and other SEC filings are largely found in Item 402 of Reg. S-K.

³ A complete copy of the Proposed Rules can be found on the SEC's Web site at www.sec.gov/rules/proposed.shtml.

⁴ Total compensation is the basis for which executives, other than the principal executive officer and principal financial officer, are named executive officers for whom compensation is reported, and stock and option awards (equity compensation) flow through to total compensation. Because the full grant date fair value includes the amount of equity compensation a company decides to award in a fiscal year, where the financial statement recognition method uses the dollar amount recognized for financial statement reporting purposes, the two methods could lead to differing total compensation numbers. See SEC Release No. 33-9052 at 15-19.

⁵ Currently, companies need only identify their compensation consultant(s), discuss the role of compensation consultants in helping to set executive and director compensation, state whether a consultant is employed by the compensation committee or similar body, describe the nature and scope of their assignment, and describe the material elements of instructions given to the consultants under their engagement with a given company. Reg. S-K, Item 407(e)(iii).

⁶ Additional services include consulting on any broad based plan that does not discriminate in favor of executive officers or directors and that is available to all salaried employees. See SEC Release No. 33-9052, at 122.