July 21, 2009

SEC Proposes Rules Concerning Proxy Disclosure of Executive Compensation and Corporate Governance and Shareholder Approval of Executive Compensation of TARP Recipients


- New disclosure requirements, to be included in the Compensation Discussion and Analysis, regarding the registrant’s overall compensation policies and their impact on risk taking;
- A change in the method of disclosing the registrant’s stock and option awards for named executive officers and directors in the Summary Compensation Table and Director Compensation Table;
- Expanded disclosure related to director and nominee qualifications and past legal proceedings;
- New disclosure related to the registrant’s leadership structure and the board’s role in the risk management process; and
- New disclosures regarding potential conflicts of interest of the registrant’s compensation consultants.

On July 1, 2009, the SEC issued proposed regulations enhancing the disclosure of compensation and corporate governance matters that registered companies are required to provide to their shareholders. The text of the proposed rules is available at http://www.sec.gov/rules/proposed/2009/33-9052.pdf. The proposed rules include:

- New disclosure requirements, to be included in the Compensation Discussion and Analysis, regarding the registrant’s overall compensation policies and their impact on risk taking;
- A change in the method of disclosing the registrant’s stock and option awards for named executive officers and directors in the Summary Compensation Table and Director Compensation Table;
- Expanded disclosure related to director and nominee qualifications and past legal proceedings;
- New disclosure related to the registrant’s leadership structure and the board’s role in the risk management process; and
- New disclosures regarding potential conflicts of interest of the registrant’s compensation consultants.

Enhanced Compensation Disclosure

Compensation Discussion and Analysis

The compensation discussion and analysis ("CD&A") was added to the executive compensation disclosure requirements in August 2006. It is designed to be a narrative discussion of the material elements of a company's compensation for its named executive officers, as disclosed in the data provided in the accompanying tabular disclosures. The SEC is proposing to expand the CD&A's scope by requiring a discussion of policies and actual practices for employees generally if the risks arising from those policies or practices may have a material effect on the company.

The SEC has provided examples of situations that may trigger this type of discussion, including policies or practices at any business unit that (i) carries a significant portion of the company's risk profile; (ii) has a different compensation structure than the rest of the company; (iii) is more profitable than others within the company; or (iv) has compensation expense that is a significant percentage of the unit's revenues. Other circumstances where discussion of this type may be warranted include a compensation policy that varies significantly from the company's overall risk and reward structure, such as bonuses awarded upon accomplishment of a task when both the income and risk from that task extend over a significantly longer period of time.

While the SEC recognizes that disclosure will vary based on each company's business and compensation philosophy, it has provided examples of issues that may need to be addressed for any business unit discussed, if deemed to be material. Examples include:

- The general design and manner of implementation of the policies whose incentives most affect employee behavior and how such polices relate to or affect risk taking;
- The company's risk assessment or incentive considerations in structuring such policies or in awarding and paying compensation;
- How policies such as clawbacks or holding period requirements relate to the realization of risks;
- Policies regarding adjustment to compensation programs in order to address changes in risk profile and any material adjustments that have actually been made; and
- The extent to which the company monitors its policies to determine whether its risk management objectives are being met in terms of incentivizing employees.
The SEC has requested comment as to whether a company that does not reasonably expect its broader compensation policies to have a material effect on the company be required to affirmatively state so in its compensation discussion and analysis.

**Tabular Disclosure of Stock and Option Awards**

Currently, the value of equity awards in the Summary Compensation Table and Directors Compensation Table reflects the expense attributable to the equity awards in the applicable fiscal year rather than the grant date fair value of awards made during the year. The grant date fair value is shown only in the Grants of Plan Based Awards Table and in footnote disclosures to the Directors Compensation Table.

The SEC is now proposing to require that the Summary Compensation Table and the Directors Compensation Table include the grant date fair value of equity awards granted in the applicable fiscal year. In connection with this proposal, the SEC has stated it intends to require companies, for the 2010 proxy (reporting 2009 compensation), to recompute options and stock award values (as well as an amended "total compensation" amount) in accordance with the new rules and disclose these figures for each of the prior years that are required to be included in the Summary Compensation Table. These new computations, however, would be for informational purposes and would not require a company to change the individuals that were reported as its named executive officers for any preceding year or amend an earlier filing.

Under the proposal, any salary or bonus foregone at the election of the named executive officer in exchange for equity or other non-cash based awards would no longer be reported in the respective salary or bonus column. Rather, it would be included in the appropriate equity award column, which the SEC believes would more accurately reflect the actual compensation received by the executive.

**Enhanced Director and Nominee Disclosure**

For purposes of supplementing the general information about directors and nominees currently included in the proxy statement disclosures, the SEC is proposing amendments requiring a more specific discussion of the backgrounds of these individuals. Presently, disclosure of only the individuals’ biographies, including business experience over the past five years, current directorships and certain legal proceedings dating back five years, is required.

Under the proposed amendments, the discussion concerning the background of directors has been expanded to include a discussion of the director’s or nominee’s specific experience, qualifications, attributes or skills that qualify that person to serve as a director and as a member of any committee that
the director serves on at the time of the disclosure. If material, this discussion should include information about the person’s risk assessment skills, particular area of expertise or other relevant experience and may include information that extends beyond the five years that is currently required.

In addition, the proposed amendments would require the disclosure of all other directorships that a director or nominee has held during the past five years (and not just the individual’s current directorships). Similarly, the proposed rules expand the period for disclosure of past legal proceedings from five to ten years.

*Company Leadership Structure and the Board’s Role in the Risk Management Process*

The proposed rules would require disclosure regarding the company’s leadership structure and the board’s role in the company’s risk management process. All registrants would have to briefly describe their leadership structure, including whether the same person serves as both principal executive officer and chairman of the board or whether two individuals serve in those roles. The disclosure should discuss why the company believes its leadership structure is appropriate given the specific characteristics and circumstances of the company at the time of filing.

As part of this new requirement, disclosure about the board’s role in the company’s risk management process and the effect this has on the company’s leadership structure would be required. The preamble to the proposed rules states that the SEC is seeking information about how a company perceives the role of its board, including its relationship to senior management, in managing the material risks facing the company. Examples of types of risk that may be relevant include credit risk, liquidity risk and operational risk. It is suggested that disclosure may include whether the board implements its risk management function through the board or through a committee and whether the employees who oversee risk management report to the board or such committee.

*Disclosure Regarding Compensation Consultants*

The proposed rules would expand the disclosure relating to a company’s compensation consultants that provide other services to the company in addition to their work related to executive and director compensation. In that case, the company would be required to disclose (i) the nature and extent of the additional services provided during the last fiscal year, (ii) the aggregate fees paid for all additional services and the aggregate fees paid for determining executive officer and director compensation, (iii) whether management screened or reviewed the decision to engage the compensation consultant for non-executive compensation work and (iv) whether the board of directors approved these services in addition to the executive compensation services.
Say on Pay Votes for TARP Recipients

In the proposed say on pay rule, the SEC formalized instructions for companies that are required to include a separate, non-binding shareholder vote to approve the compensation of executives in their annual proxy statement. The inclusion of a say on pay vote is mandated for companies receiving financial assistance under TARP as part of the executive compensation and corporate governance standards imposed by EESA, as amended by ARRA. For more information on EESA, ARRA and the Treasury’s interim final rule please refer to our previous memorandum “New Executive Compensation Guidance and Legislative Proposals” at http://www.ffhsj.com/siteFiles/Publications/BDBED5B680BEBEC7CFD263F04BC21C73.pdf.

Under the proposed regulations, information regarding the say on pay vote would be required only in a proxy solicited in connection with an annual shareholder meeting (or special meeting) in which directors will be elected. The TARP recipient (as defined in EESA) must disclose that it is providing for a separate shareholder vote on executive compensation. While the proposed regulation does not mandate any specific language or a form of resolution, EESA provides that the vote should be to approve the overall compensation of executives, as disclosed in the proxy statement, including the CD&A, the compensation tables and any related material. A smaller reporting company that is not required to provide a compensation discussion and analysis section would not be required to add such a section just to comply with the new say on pay proposal rules. In addition, a TARP recipient must briefly explain in the proxy statement itself the general effect of the shareholder vote, including whether or not it is binding on the company.

While generally a proxy statement that includes proposals on only routine matters, such as the election of directors, would be exempt from the Exchange Act requirements for a preliminary proxy filing, the SEC noted that a say-on-pay proposal would not be considered exempt. Therefore, absent an amendment to Rule 14a-6, a TARP recipient would need to file a preliminary proxy statement with the SEC at least ten days before it is sent to shareholders.

The SEC’s July 10th release also proposes amendments to the proxy solicitation rules to provide clarification on aspects of these rules as well as amendments to Form 8-K requiring that annual or special shareholder meeting voting results be reported on a Form 8-K within four business days of the meeting.

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The SEC has requested comments on many of the proposals described above. Although some changes may be expected, it is likely the final rules will, if adopted generally apply beginning with the 2010 proxy season. Companies should begin analyzing compensation programs and policies that cover employees...
generally and determine what effect those programs and policies may have on risk-taking at the company. In addition, companies will need to prepare for the changes required in the reporting of stock and option awards for the current year and recalculating the information shown for the last two fiscal years. Companies may also need to ask their directors for more information regarding their background and qualifications, and should also consider the board’s role in the company’s risk management programs. Finally, companies should review their relationships with compensation consultants to determine if additional disclosures will be needed, and begin to consider their disclosure regarding their overall leadership structure.

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