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Anticipating New Exec Compensation, Disclosure Rules

Law360, New York (October 06, 2009) -- The U.S. Securities and Exchange Commission has issued a set of proposals to improve proxy statement disclosure of important matters relating to executive compensation and corporate governance.

The proposals would require companies to report additional information about the relationship between compensation incentives and corporate risk, the qualifications of their directors, a justification of their board leadership structure and their relationships with compensation consultants. If adopted, the proposed rules will be effective for the 2010 proxy season.

Companies should begin to assess current compensation and governance practices and policies now so that they are prepared to comply with the new disclosure requirements once they are finalized. The most significant of these changes are as follows:

Relationship Between Compensation Policies and Risk

The proposals include expanding the Compensation Discussion & Analysis section of the proxy statement by adding a new section that would provide information about how the company's overall compensation policies for its employees (not limited to executive officers) create incentives that can affect the company's risk and management of that risk.

This disclosure, however, would only be necessary to the extent that risks arising from compensation policies or practices may have a material effect on the company. This proposal borrows from similar requirements already in place for financial institutions participating in the Treasury Department's TARP program.

The SEC believes that this type of disclosure can help investors identify whether the company has a system of incentives that can lead to excessive or inappropriate risk-taking by its employees.

The fundamental challenge for management and directors if these proposals become finalized — as they, in all likelihood, will in some form — will be to assess and articulate compensation policies and practices in a new light.

Directors, particularly for companies that are not in the financial services industry, typically do not consider compensation policies and practices to be an element of corporate risk management.

Compensation committees should not wait until final rulemaking to begin considering these issues in making compensation decisions and thinking about how best to analyze and explain the interplay between compensation and risk taking within their enterprise.

Reporting of Equity Awards

The Summary Compensation Table and Director Compensation Table disclosure of stock awards and option awards would be revised to require disclosure of the aggregate grant date fair value of awards computed in accordance with FAS 123R.

The proposed revised disclosure would replace currently mandated disclosure of the dollar amount recognized for financial statement reporting purposes for the fiscal year in accordance with FAS 123R.

This proposed change is intended to improve disclosure by focusing on the value of stock awards that are granted in the year rather than the current year accounting for awards granted in prior periods and would result in the disclosure of higher compensation amounts.

Qualifications of Directors and Director Nominees

Also under the SEC's proposals, companies would need to disclose the particular experience, qualifications, attributes or skills that qualify each director and director nominee to serve as a director of the company and as a member of any committee that the person serves on, in light of the company's business and structure.

If material, this disclosure should cover more than the past five years, as currently required, and include information about the person's risk assessment skills, particular areas of expertise or other relevant qualifications.

In addition, companies would be required to disclose any directorships held by each director and nominee at public companies at any time during the past five years, and to disclose any material legal proceedings in which a director or director nominee was involved during the prior 10 years.

Company Leadership Structure

Under the proposed rules, additional proxy statement disclosure would be required to describe the company's leadership structure. This would include discussion of whether the same individual serves as both principal executive officer and chairman of the board, or whether two different individuals serve in those capacities.

If it is a single individual, the company would have to disclose whether it has a lead independent director and describe the specific role the lead independent director plays in the leadership of the company.

The company would also be required to explain why it believes that its leadership structure is appropriate given the company's specific characteristics or circumstances.

The extent of the board of directors' role in the company's risk management process would be also disclosed, including the effect that this involvement has on the company's leadership structure.

Compensation Consultants

The SEC is also proposing to require disclosure regarding the fees paid to compensation consultants and their affiliates when they play any role in determining or recommending the amount or form of executive and director compensation, if they also provide other services to the company.

Additionally, the proposed amendments would require a description of any additional services provided to the company by the compensation consultants and any of their affiliates.

These disclosures are intended to enable investors to assess any conflicts a compensation consultant may have in recommending executive compensation and better assess the compensation decisions made by the board of directors.

Additional Areas of SEC Interest

The SEC is also soliciting comments regarding other ways in which proxy statement disclosure might be improved. The following areas were specifically highlighted in the release as potential changes:

- Expanding disclosure to include compensation paid to each executive officer, not just the "named executive officers;"
- Eliminating the ability to exclude financial and non-financial performance targets from the CD&A based on the adverse competitive effect on the company that could potentially result from such disclosure;
- Adding a requirement to disclose whether or not a company has "hold to retirement" or "clawback" policies in place and, if not, why not; and

- Adding a requirement to disclose internal pay ratios of a company, such as disclosure of the ratio of the total compensation of the named executive officers, or total compensation of each individual named executive officer, to the total compensation of the average non-executive employee of the company.

The SEC's proposed rules reflect the increased scrutiny of public company compensation and governance practices on the part of shareholders, investors, regulators and Congress.

Although they remain subject to comment and revision, some version of these proposals is intended to be finalized in time for the 2010 proxy season.

All reporting companies, therefore, should begin to consider the implications of the proposed rules within the context of their own policies and practices, to bear them in mind in connection with compensation and other decisions and to gather and organize the relevant additional information needed to comply with these new disclosure requirements.

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