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SEC Adopts Amendments to Proxy Statement Disclosure Rules

On December 16, 2009 the SEC adopted amendments to the proxy statement disclosure rules. The new rules, which affect compensation and corporate governance disclosures, are effective for definitive proxy statements filed on or after February 28, 2010 by companies whose fiscal year ends on or after December 20, 2009. The key changes made by the amendments are described below.

Compensation Policies and Practices Relating to Risk Management

Under the new rules, companies (other than "smaller reporting companies") will be required to discuss their compensation policies and practices for employees as they relate to risk management and risk-taking incentives if such policies and practices create risks that are "reasonably likely to have a material adverse effect" on the company. The requirement applies to all employees, not just executive officers.

In response to comments on the rule initially proposed, the threshold triggering this disclosure has been tightened from "may have" to "reasonably likely to have" the requisite effect, and the rule has been clarified so that only material "adverse" effects will trigger the disclosure. The adopting release makes clear that, in determining whether a particular compensation structure is reasonably likely to have a material adverse effect, companies are permitted to consider policies that mitigate risk-taking incentives and controls that are designed to limit the risks of the compensation structure. In another change from the form of the rule as initially proposed, the disclosure for employees (other than the named executive officers) will not be part of the CD&A.

The rule sets forth a non-exclusive list of the types of situations in which compensation programs may have the potential to incentivize employees to create material risks for a company. These situations include compensation policies and programs at a business unit of the company:

- that carries a significant portion of the company's risk profile;
- that has compensation structured in a significantly different manner from the rest of the company;
- that is significantly more profitable than the rest of the company;
- where the compensation expense is a significant portion of the unit's revenues; or
- where compensation practices vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon completion of a task while the company's income and risk from the task extend over a significantly longer period of time.

The scope of the required disclosure is somewhat open-ended. The requirement is to "discuss" the company's compensation policies and practices "as they relate to risk management practices and risk-taking incentives." In an approach similar to that of the CD&A, this basic requirement is fleshed out by examples of the types of issues that the company may need to address:

- the general design philosophy behind the particular compensation policies and practices, and the manner of their implementation, particularly as they relate to risk-taking by employees;
- the company's risk assessment or incentive considerations in structuring the compensation program;
- how the company's compensation policies and practices relate to the realization of risks resulting from employee actions, such as through policies requiring claw backs or imposing holding periods;

- the company’s policies regarding adjustments to its compensation policies and practices to address changes in its risk profile;
- material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and
- the extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing employees.

Reporting of Stock and Option Awards

Under the new rules, stock and option awards are required to be reported in the Summary Compensation Table and Director Compensation Table using the full grant date fair value of the award for the year of grant rather than reporting the amount expensed during the year for financial statement reporting purposes. Awards that are subject to performance conditions are to be valued based on the probable outcome of the performance condition, as determined at the grant date, rather than on the maximum possible payout of the award. However the maximum value of the award must be disclosed in a footnote to the tables. Companies will continue to be required to report the full grant date fair value on an award-by-award basis in the Grants of Plan-Based Awards Table (or as a footnote to the Director Compensation Table).

The new rules resolve an uncertainty as to the proper year for which a grant is to be reported where the award is made in Year 2 as compensation for services rendered in Year 1. The rules provide that in this situation the award is required to be shown in the table for the year in which it was granted, even if the award was granted for services in the prior fiscal year. However the adopting release points out that a discussion of awards granted after the end of the fiscal year may be required in the CD&A if such disclosure is necessary for a fair understanding of the officers’ compensation for the fiscal year.

In order to facilitate year-to-year comparisons, companies are required to restate the rows of the Summary Compensation Table reflecting compensation paid in prior years to conform them to the required presentation for 2009.

Director and Nominee Disclosure

Director Qualifications. The new rules require disclosure, for each director and nominee, of the particular experience, qualifications, attributes, or skills that led the board to conclude that the person should serve as a director of the company. The disclosure is required even for directors who are not up for re-election, and is required to speak as of the year of filing (not as of the time the director was last nominated). The new disclosure is in addition to the existing requirement to disclose any specific minimum qualifications established by the nominating committee and any particular skills sought by them when considering potential nominees. The Commission did not adopt the proposal that the disclosure also address each director’s qualifications to serve as a member of the committees on which he or she serves. However, the adopting release states that if a person was chosen to be a director because of particular qualifications related to service on a specific committee, this should be disclosed under the rule, as part of the individual’s qualifications to serve on the board.

Other Directorships. The new rules create a lookback period for disclosure of all directorships held by each director and nominee at public companies and registered investment companies. In addition to current directorships, the new requirement covers those held at any time during the past five years.

Legal Proceedings. The new rules extend the lookback period for disclosure of legal proceedings involving directors, nominees, and executive officers to ten years (extended from five), and also expand the types of proceedings that require disclosure. The additional types of proceedings that must be disclosed include:

- judicial or administrative proceedings based on mail or wire fraud or fraud in connection with a business entity;
- judicial or administrative proceedings based on violations of federal or state securities, commodities, banking, or insurance laws or regulations; and

- disciplinary sanctions imposed by a stock, commodities, or derivatives exchange or other self-regulatory organization.

Board Diversity. The existing provision requiring description of the nominating committee's process for identifying and evaluating director nominees has been amended to expressly require disclosure of whether, and if so how, the nominating committee or board considers diversity in identifying nominees for director. In addition, if the nominating committee or board has a policy with regard to the consideration of diversity in identifying directors, the company is required to describe how the policy is implemented and how the nominating committee or board assesses the effectiveness of the policy.

The rules do not define diversity, leaving companies free to define the concept as they deem appropriate. The adopting release notes that some companies may define the concept expansively, to include differences in viewpoint, experience, and other individual differences, while others may choose to focus on diversity in race, gender, and national origin.

Board Leadership Structure

The new rules require a company to describe the leadership structure of the company's board and the reasons the company believes that structure is appropriate for it. Specifically, the company is required to describe whether it has chosen to combine or separate the positions of CEO and board chairman, and the reason for its choice. In addition, if these two positions are combined, the company is required to disclose whether it has a lead independent director, and the specific role that director plays in the leadership of the board.

Board Role in Risk Oversight

The new rules require disclosure of the board's role in the oversight of the company's risk management practices. This disclosure would include how the board administers its oversight function and the effect this has on the board's leadership structure. The adopting release indicates that this disclosure could encompass items such as:

- whether the risk oversight function is performed by the board as a whole or through a specified committee;
- whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board or committee, or how the board or committee otherwise receives information related to risk oversight; and
- whether and how the board or committee monitors risk.

Compensation Consultants

The prior requirement to disclose the role played by executive compensation consultants has been expanded to require disclosure of the fees paid to such consultants in certain circumstances.

- If the compensation committee or the board has engaged its own consultant to provide advice or recommendations on the amount or form of executive or director compensation, and the consultant (or its affiliates) provided over $120,000 of other services to the company, the company must disclose the aggregate fees for the executive and director compensation services and the aggregate fees for the other services. In addition, the company must disclose whether the decision to engage the consultant for the other services was made or recommended by management, and whether the compensation committee or board approved such other services.
- If management has engaged a consultant to provide advice or recommendations on executive or director compensation, the consultant (or its affiliates) provided over $120,000 of other services to the company, and the compensation committee or the board has <u>not</u> engaged its own compensation consultant, the company must disclose the aggregate fees paid for the executive and director compensation services and the aggregate fees paid for the other services.

- In either of the above situations, no fee disclosure is required if the only role of the consultant is (i) consulting on broad-based plans that do not discriminate in scope, terms, or operations in favor of executive officers or directors, or (ii) providing information, such as surveys, that either is not customized for the company or is customized based on parameters that are not developed by the consultant, provided that the consultant does not provide advice in connection with such information.
- No fee disclosure is required with respect to compensation consultants that work with management (whether or not they provide services in addition to executive compensation consulting) if the board or compensation committee has its own compensation consultant.

Reporting of Voting Results on Form 8-K

The new rules also move the requirement to disclose the results of all shareholder votes from Forms 10-Q and 10-K to Form 8-K. Preliminary voting results must be disclosed within four business days after the day on which the shareholder meeting ended. Final voting results must be disclosed on an amended Form 8-K within four business days after such results are known. However, if final results are known and disclosed within four business days of the meeting, the preliminary results need not be disclosed. The specific information required to be disclosed is substantially the same as was previously required to be disclosed on Forms 10-Q and 10-K, but the text of the Item has been simplified.

For more information about the proxy statement disclosure rules or Hughes Hubbard's executive compensation and corporate governance practices, please contact any of the following attorneys:

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