December 21, 2009

The SEC's Holiday Gift:
Final Rules for 2010 Compensation and Corporate Governance Disclosures

The SEC's newly finalized rules for expanded disclosure of compensation and corporate governance[1] include meaningful and practical changes and clarifications to its original proposal released in July[2]. The amended rules, adopted Dec. 16 by a 4-1 vote, will apply to proxies filed on or after February 28, 2010.

While generally similar to the proposed version, the approved rules differ in several key areas:

Compensation-Related Risk Disclosure

- Reporting required only where risks are "*reasonably likely to have a material adverse effect on the company*"
- Exempts smaller reporting companies from risk disclosure
- Separates risk disclosure from the Compensation Discussion and Analysis (CD&A)

Reporting Grant Date Fair Value in Summary Compensation Tables (SCT)

- Performance-based awards valued based on "probable outcome" of performance conditions, rather than maximum potential value
- Preserves last column of the Grants of Plan-Based Award Table (GPBAT) for grant date values of individual grants

Heightened Compensation Consultant Disclosure

- Limits disclosure to engagements for non-executive compensation services in excess of $120,000
- Allows additional carve-outs for survey data and other specific arrangements

Enhanced Director and Nominee Disclosure: Requires additional disclosure of whether and how the nominating committee considers diversity in identifying directors

Board Leadership Structure and the Board's Role in Risk Oversight: Clarifies that companies must disclose the Board's role in *oversight* (as opposed to *management*) of risk

This Client Alert discusses in more detail the terms of the approved rules and major differences from the SEC's earlier proposal with respect to executive compensation and Board governance.

---

[1] A complete copy of the adopting release can be found at http://www.sec.gov/rules/final/2009/33-9089.pdf

[2] See our previous Client Alert dated July 20, 2009, at http://pearlmeyer.com/knowledgecenter/alerts/ClientAlert-7.20.09.pdf for a complete recap of the proposed rules.

Copyright ©2009 Pearl Meyer & Partners, LLC

Compensation-Related Risk Disclosure

The Standard: Companies are required to provide a discussion about situations in which *any employee* compensation programs may "create incentives that can affect the company's risk and management of that risk." Currently, such proxy discussion is generally limited to compensation programs and policies for Named Executive Officers (NEO).

The SEC's earlier proposal would have required proxy disclosure of any risks arising from programs that *may have a material effect* on the company. In response to numerous comments that such a speculative standard would lead to voluminous and unnecessary extra disclosures, the SEC has narrowed disclosure to risks that are "*reasonably likely to have a material adverse effect on the company.*" The "reasonably likely" standard is closer to the risk disclosure threshold in the MD&A, which is limited to known trends and uncertainties that are material to the business. The SEC also clarified that: (i) if policies exist to mitigate or balance risk, the company may conclude that its compensation practices do not meet the "reasonably likely" threshold, and (ii) the risk need not be reported if it does not have an *adverse* effect.

Location: Risk disclosure will be provided outside of the CD&A in new Item 402(s). The proposed amendments would have incorporated the risk discussion into the CD&A, even though it contains both executive and non-executive information, but numerous comments were submitted to the SEC that it would be confusing to expand the CD&A beyond the NEOs.

Exemption for Smaller Reporting Companies: The final rules exclude smaller companies (those with a public float of less than $75 million) from the risk disclosure requirements, on the ground that such organizations are less likely to have pay compensation policies and practices that pose substantial risks.

Affirmative Statements For No Risk Not Necessary: The SEC clarified that a company does not need to formally state in the proxy that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company, if this is the case.

Examples of Materiality: While materiality is a facts and circumstances analysis, the SEC provides samples of the types of policies and situations that could trigger such disclosure, which are the same as those set forth in the proposed amendments:

- A business unit of the company that carries a significant portion of the company's risk profile;
- A business unit with a significantly different compensation structure from the rest of the company;
- Business units that are significantly more profitable than others;
- Business units in which compensation accounts for a significant percentage of revenues; or
- Programs that vary significantly from the company's overall risk and reward structure, such as payment of bonuses related to objectives for which the revenue and associated risk to the company will extend over a significantly longer period.

©2009 Pearl Meyer & Partners, LLC

Sample Disclosures: If risk disclosure is triggered, the SEC provides examples of information that may need to be provided, similar to those cited in the earlier proposal:

- The general design philosophy of compensation policies for employees whose behavior would be most affected;
- Any risk assessment or incentive considerations used in structuring, awarding and delivering compensation;
- Policies that address short-term and long-term compensation risks, such as claw backs or holding periods;
- How compensation policies are adjusted to address changes in the company's risk profile;
- Any material adjustments made to compensation policies or practices due to changes in the company's 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 motivating its employees.

> ***PM&P Observation:*** While the new rules only require disclosure where the risks are reasonably likely to have a material adverse effect on the company, companies will nonetheless have to implement processes to ensure that they have appropriately conducted the risk assessment. Taken together with the disclosure required of the Board's role in risk oversight (discussed below), the risk disclosure is potentially reduced, but the work involved remains significant.

Reporting of Equity Award Values in the SCT and DCT

Grant Date Fair Value Reporting of Equity: The SEC reversed its current requirement that aggregate equity grants be generally reported using financial statement expense values in the SCT and Directors Compensation Table (DCT). The new reporting standard will be the aggregate grant date fair value in accordance with FASB ASC Topic 718 (formerly known as FASB Statement 123R).

- The SEC, as well as numerous commentators, believes that returning to the use of grant date fair value will permit investors to better evaluate the value of equity compensation awarded for that year.
- The Commissioners also recognized that many practitioners and investors already focus on this value, which currently is reported in the last column of the GPBAT, rather than what is in the SCT or DCT.

Special Rule for Performance-Based Equity Awards: Currently CD&I 120.05 requires that the "grant date fair value" for performance-awards reported in the last column of the GPBAT be valued at maximum – a position that is consistent with FASB ASC Topic 718. The SEC received voluminous commentary that application of this methodology for grant date fair values in the Stock and Option awards columns in the SCT (and consequently the Total column) would

©2009 Pearl Meyer & Partners, LLC

overstate fair values and result in the unintended consequence of discouraging companies from granting performance-based awards. In response, the final rule clarified that the grant date fair value of performance-based awards in the SCT, DCT and GPBAT will be based on the "*probable outcome of the performance conditions*." That amount is intended to be consistent with the grant date estimate of compensation cost to be recognized over the service period, excluding the effect of forfeitures. The maximum value, assuming the highest level of performance, will only be required in the footnotes to the SCT and DCT.

> ***PM&P Observation:*** While the rules do not specifically state so, in most cases the "probable outcome" of the performance conditions at the time of grant will be target.

Last Column of GPBAT Retained: The SEC originally proposed rescinding the current requirement to report the full grant date fair value of each individual equity award in the GPBAT, since aggregate fair values would be reported in the SCT. In a reversal of this position, the SEC will maintain this column, agreeing with commentators that individual grant disclosure provides investors with useful information in addition to the aggregate information presented in the SCT under the new rules.

Equity Awards To Be Reported in Fiscal Year Granted: The SEC concluded that equity should continue to be reported with respect to year granted, in accordance with FASB ASC Topic 718, on the ground that any other method would result in too many inconsistencies and potential manipulation. The SEC had sought comments as to whether values should be reported when granted or corresponding to the performance year for the award. However, the SEC said if companies believe the former approach is not accurately reflected in the SCT decision-making for the year, they can supplement the tables with narrative and/or supplemental tables.

Salary and Bonus Forgone at NEO Election Continues To Be Reported in Salary or Bonus Columns: The SEC, reversing its earlier position, agreed with commentators that disclosing salary and bonus in the Salary and Bonus columns, respectively, better enables investors to understand the relative weights that the Compensation Committee applied to annual incentives and salary. The proposed amendments would have required any salary or bonus forgone at the NEO's election into equity be reported in the applicable equity column, rather than the Salary or Bonus columns.

Transition Rule: Companies must transition to the grant date fair value disclosure for fiscal years ending on or after December 20, 2009. Prior fiscal year data in the SCT must be recomputed with respect to equity awards and total compensation. The SEC made its decision after seeking comment on the appropriate transition for the SCT. The new rules further provide that if a person who would be a NEO for the most recent fiscal year (2009) also was disclosed as a NEO for 2007, but not 2008, the NEO's compensation for each of those three fiscal years must be reported. However, companies are not required to include different NEOs for any preceding fiscal year based on recomputing total compensation for those years.

©2009 Pearl Meyer & Partners, LLC

> ***PM&P Observation:*** Companies should act now to estimate new total values for executives whom they expect will be disclosed in the 2009 SCT, which may differ from those originally contemplated under the former reporting rules. They should also discuss how to address any potential optics issues resulting from re-reported disclosures for 2007 and 2008.

Enhanced Compensation Consultant Disclosure

In response to concern about potential conflicts of interest when executive compensation consultants perform additional services for the company, the SEC included additional disclosure of any "other services" provided to a company or its affiliates by its compensation consultants.

Existing Requirements: Currently, the disclosure in Item 407(e) is limited to identification of the consultant; their role in determining or recommending the amount or form of executive and Director compensation; the nature and scope of the assignment; whether the consultant is engaged directly by the Compensation Committee or another person; and the material elements of the instructions or directions given to the consultant with respect to the performance of duties.

Final Requirements: In the final rules, the SEC requires additional levels of disclosure in the case where a compensation consultant performs both executive compensation consultant services and "other services", as follows:

- If the Board or Committee engages its own compensation consultant, and this consultant also provides "other services" to the company (in excess of $120,000), the additional disclosures will include:
  - The consultant's aggregate fees related to advising on executive and Director compensation;
  - The consultant's aggregate fees related to other services;
  - Whether management directly engaged, or otherwise participated in, the decision to engage the consultant for other services; and
  - Whether the Board or Compensation Committee approved the other services.
- If the Committee has not engaged a compensation consultant, but management has engaged a compensation consultant to provide executive compensation consulting services and such consultant has provided "other services" to the company (in excess of $120,000), the additional disclosures will include:
  - The consultant's aggregate fees related to advising on executive and Director compensation; and
  - The consultant's aggregate fees related to other services.
- If the Committee has its own consultant separate from that of management, none of the additional disclosures will be required for consultants that work for management even if such consultants perform both executive compensation and "other services" to the company.

In response to much commentary, the SEC narrowed the scope of the original proposal with respect to this rule as follows:

- $120,000 Threshold for "Other Services": The obligation to make additional disclosures will only be triggered when fees for "other services" exceed $120,000 during the fiscal year.
- Exception for Broad-Based Plans and Certain Surveys: Services that involve only broad-based non-discriminatory plans, or survey information that is not customized for the company, or that are customized based on parameters not developed by the consultant, will not be treated as executive compensation consulting services for purposes of disclosure.
- Elimination of the Description of Nature and Extent of "Other Services": The final rules dropped this requirement, reasoning that such disclosure could raise competitive concerns for many compensation consulting firms.

> ***PM&P Observation:*** In an environment of heightened scrutiny and skepticism about all executive compensation processes and decisions, it seems likely that Committees will choose to avoid the appearance of a conflict of interest and the additional disclosure by retaining a compensation consultant that is independent in both appearance and form.

Director Qualifications

Under the current rules, required background information for incumbent Directors and nominees is limited to brief biographical data. These requirements have been significantly expanded under the new rules. Companies will be required to discuss the specific expertise, skills and qualifications that qualify an individual to serve as a Director in light of the company's business. The SEC dropped an earlier proposal to also require an explanation for placing individual Directors on Board committees, after commentators noted that many companies rotate their Directors among committees to promote different perspectives.

The new disclosures require information regarding:

- Any directorships held at any time *during the past five years* at public companies (vs. the existing reporting of only current directorships)
- Involvement in any legal proceedings *for the past ten years* (vs. the current rule of five years)
- Whether and how the nominating committees consider diversity in identifying director nominees – a requirement that was not formally proposed in July, but on which the SEC had solicited comment. Companies must disclose if they have a policy for considering diversity in identifying director nominees, how any such a policy is implemented, and how its effectiveness is assessed.

©2009 Pearl Meyer & Partners, LLC

PM&P Observation: The SEC indicated that companies may define diversity in ways that they consider appropriate, including differences in viewpoint, professional experience, education, skill, and other individual qualities and attributes that contribute to Board heterogeneity, in addition to race, gender and national origin.

PM&P Observation: As the final rules will be effective for this proxy season, record-keeping questionnaires presented to Directors and officers should be immediately revised.

Board Leadership Structure and Board's Role in Risk Oversight

The SEC believes investors make better voting and investment decisions when they have meaningful information about corporate governance practices, particularly the Board's leadership structure. Under the new rule, companies must disclose their rationale for the Board's leadership structure at the time of filing, including why the positions of Chief Executive Officer and Board Chair are combined or separate. Where the two roles are combined, companies must disclose whether they have a lead independent Director, and the role that the lead independent Director plays in the Board's leadership structure or governance.

Given the role that risk played in the recent market turmoil, the SEC also believes investors need better disclosure regarding how a Board provides risk oversight. Under the final rules, companies will need to disclose the extent of the Board's role in the risk oversight of the company, such as how the Board administers its oversight function and the effect on the Board's leadership structure. The proposed amendment would have necessitated disclosure of *management*, rather than *oversight*, of risk. The latter term better reflects the Board's actual role in this area.

Other Items

Accelerated Filing of Voting Results in Form 8-K: The final rules confirm the SEC's proposed accelerated reporting of voting results from annual shareholder meetings. Under the new rules, preliminary results must be disclosed within four business days in Form 8-K following the end of the meeting at which the vote was held. This reporting requirement is exponentially faster than the current rule requiring reporting in the next quarterly or annual report, which is often filed months later.

Proxy Access: The SEC had proposed several revisions related to shareholder communications and voting. Those proposals were put on hold and will be considered as part of a separate SEC initiative.

©2009 Pearl Meyer & Partners, LLC

Conclusions

We commend the SEC for revisiting many aspects of the proposed amendments and taking to heart the voluminous commentary submitted. Risk disclosure seemed to be the most controversial of the revisions, with most commentators in agreement that it would have at best resulted in a great deal of unnecessary information as proposed[3]. By raising the threshold, exempting smaller reporting companies, and giving serious attention to mitigating factors in the risk disclosure, we anticipate this requirement should now be substantially less burdensome for lower risk industries. While companies will still need to conduct a risk assessment to determine whether disclosure is necessary, actual disclosures will likely decrease from what would have been required under the earlier proposal.

Other changes, particularly those related to the impact of reporting at grant date fair value, reflect the SEC's sensible and practical approach to providing more meaningful information to investors.

Important Notice: *Pearl Meyer & Partners has provided this analysis based solely on its knowledge and experience as compensation consultants. In providing this guidance, Pearl Meyer & Partners is not acting as your lawyer and makes no representations or warranties respecting the legal, tax or accounting implications or effectiveness of this advice. You should consult with your legal counsel and tax advisor to determine the effectiveness and/or potential legal impact of this advice. In addition, this Client Alert is not intended or written to be used, and cannot be used by you or any other person, for the purpose of (1) avoiding any penalties that may be imposed by the Internal Revenue Code, or (2) promoting, marketing or recommending to another party any transaction or other matter addressed herein, and the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.*

[3] See, *e.g.*, our comments to the SEC dated September 15, 2009 which can be found at: http://pearlmeyer.com/knowledgecenter/alerts/PMP%20Staff%20Comments%20to%20SEC.pdf

www.pearlmeyer.com

NEW YORK
570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4083
atlanta@pearlmeyer.com

BOSTON
132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN JOSE
2880 Zanker Road, Suite 203
San Jose, CA 95134
(408) 954-7399
sanjose@pearlmeyer.com