



## The SEC's New Disclosure Proposals

**O**n July 1, 2009, the Securities and Exchange Commission voted unanimously to solicit comment on several proposed changes to its rules on the disclosure of corporate governance and executive compensation information in proxy statements. These proposals fulfill commitments made earlier in the year by SEC Chairman Mary L. Schapiro to revisit the current disclosure requirements in light of the ongoing economic turmoil to ensure that investors are receiving the right information about public companies' leadership and compensation practices.

Although SEC officials had suggested that a number of possible changes were being considered, the executive compensation-related proposals focus on just three specific topics – a compensation and risk discussion, the change of the reporting of equity awards, and enhanced disclosure about compensation consultants. Two of these proposals – the risk discussion and the compensation consultant disclosure – can be traced

directly to the executive compensation standards of the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009, while the third rectifies a requirement that, on balance, was responsible for many of the challenges and complexities in the current rules.

At this stage, the risk discussion will probably present the greatest challenge for technology and life sciences companies. Unlike financial institutions, which often use highly-leveraged annual bonus awards as the centerpiece of their executive compensation programs, most technology and life sciences companies maintain relatively modest short-term incentive plans, which are supplemented with long-term incentives that typically involve equity awards. Consequently, while, under the SEC proposal, these companies will still need to conduct risk assessments, it is likely that most will conclude that the risks associated with their compensation programs do not have a material impact on their business.

### **The SEC is considering the following changes to its proxy disclosure requirements:**

- A new discussion in the CD&A about the risks associated with a company's general compensation policies and practices if these risks may have a material impact on the company
- Expanded disclosure about the services provided and fees received by a compensation consultant where the consultant performs more than just executive pay work for a company
- The reporting of equity awards in the Summary Compensation Table and Director Compensation Table on the basis of their full grant date fair value
- Enhanced disclosure of the qualifications and skills of directors and director-nominees
- A description of a company's leadership structure and the reasons that the company has selected its specific structure
- Accelerated reporting of the voting results from the annual meeting of security holders



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This article summarizes the proposals and offers our initial analysis of the likely implications of the proposed changes.

### The Discussion of Compensation and Risk

Consistent with the recent emphasis on the potential risks associated with incentive compensation plans and arrangements, the SEC is proposing that companies discuss in the Compensation Discussion and Analysis their compensation policies or practices as they relate to risk management practices and risk-taking incentives, to the extent that these risks may have a material impact on the company. This is in addition to the current requirement that the CD&A address the level of risk that a company's named executive officers may be encouraged to take in connection with their target incentive compensation award opportunities.

However, the proposed change is subject to a significant qualifier – the materiality of the potential risks – which has the potential to significantly flummox companies seeking to ensure compliance. To help them better understand the analysis (and related disclosure) that must be undertaken, the proposal contains examples of the type of situations that may trigger disclosure, including:

- compensation policies at a business unit of the company that carries a significant portion of the company's risk profile;
- compensation policies at a business unit with compensation structured significantly differently than other units within the company;
- compensation policies at business units that are significantly more profitable than others within the company;
- compensation policies at business units where compensation expense is a significant percentage of the unit's revenues; and

- compensation policies 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.

The proposal goes on to state that its purpose is to provide investors material information concerning how the company compensates and incentivizes its employees that may create risk. Consequently, consistent with the "principles-based" orientation of the CD&A, the proposal contains a number of examples of the type of issues that may need to be discussed, including:

- 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 "claw-backs" 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 its 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.

Finally, under a separate proposal, companies would be required to disclose the extent of their board of direc-



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tors' role in their risk management (including, but not limited to, credit risk, liquidity risk and operational risk matters) and the effect that this involvement has on the company's leadership structure. Among other things, this disclosure would be expected to address the specific processes and procedures that the board uses to monitor and manage the company's risk profile.

*Observations.* If adopted, the proposal will represent a noteworthy expansion of the scope of the CD&A. Currently, the discussion is limited to compensation matters involving a company's named executive officers. The change would extend the CD&A to cover compensation issues (albeit risk-related issues) involving non-executive employees. While this expansion is being justified on the basis of the importance of risk management as it involves all of a company's compensation programs, it will be interesting to see whether this development will lead to further disclosure of company-wide compensation issues in the future.

As to the substance of the proposal, disclosure is required only where the risks associated with a company's compensation programs may have a material impact on the company. This analysis will vary from company to company, and will be influenced by the nature of the company's business, its operating strategy, and its compensation design and structure. In most cases, the focus will center on a company's short-term and long-term incentive compensation arrangements, their coordination (or lack thereof), and any risk mitigation features that the company maintains to ensure that its compensation program serves its intended purpose. For example, companies with uncapped annual bonus plans will need to assess the risk that plan participants will drive short-term results to maximize their payouts even if to the long-term detriment of the organization. On the other hand, long-term incentive plans with rolling or overlapping performance periods or that pay out in shares that must be held for an additional service-related vesting period are examples of plans that contain risk mitigation features. These

factors, and many others, will influence the required analysis and any attendant disclosure.

Thus, while each company will be required to conduct an internal assessment of the risks associated with its compensation programs, not every assessment will result in required disclosure. At a minimum, compensation committees will need to familiarize themselves with the company's risk profile. In many cases, the required assessment will lead to greater interaction with the audit committee or other body that monitors the company's risk issues, as companies seek to coordinate this review with their other risk oversight activities and minimize any duplication of effort.

While the proposals require disclosure only where the compensation-related risks may have material implications, we expect that most companies will feel compelled to provide some level of discussion (beyond simply indicating that they conducted a risk assessment) even where the compensation committee determines that risk levels are within tolerable limits to minimize "second-guessing" (particularly where original expectations or projections turn out to be erroneous) as well as to inform investors as to how they designed their compensation programs (and the attendant risks) within the context of their business and compensation objectives and of the risk mitigation features that are incorporated into their compensation structure.

Also, many companies are likely to find that they will need to conduct two separate assessments – one for their executive officers and the other for their broader employee compensation program – where there are significant differences between their executive and general employee compensation programs. Given the typical differences in these programs, while there may be some overlap in risk-related issues, the number and type of differences will frequently necessitate separate discussions.

### Reporting of Equity Awards

The SEC is proposing to reverse its much-maligned December 2006 decision concerning the reporting of



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equity awards (stock options and other stock awards) in the Summary Compensation Table and Director Compensation Table. As proposed, companies would be required to report the aggregate grant date fair value of stock awards and stock option awards (computed in accordance with SFAS 123(R)) in the SCT and DCT, rather than the dollar amount recognized for financial statement reporting purposes during the covered fiscal year.

In addition, the SEC is proposing to simplify the current rules for reporting salary and bonus forgone at the election of a named executive officer. Instead of basing the disclosure of an elective deferral on when the decision to take equity (instead of cash) is made, the reporting would simply follow the form of the compensation.

**Observations.** This change will be welcomed by companies and investors alike; companies because it will simplify compliance and preparation of the SCT and DCT, and investors because it will restore meaning to the equity amounts reported in the tables and a modicum of integrity to the "total compensation" figures that these tables are intended to showcase. It may also alter the determination of a company's three most highly-compensated executive officers, as named executive officer status will turn on total compensation amounts that now include the full grant date fair value of equity awards granted during the last completed fiscal year, rather than just the amounts expensed during that year.

However, in reality, the change simply swaps one complexity – understanding the accounting expense recognition rules – for another complexity – the treatment of performance-based awards. Unless a creative alternative is offered during the comment process, companies that use performance-based equity awards will be required to report the full grant date fair values of these awards, even though a named executive officer actually may earn a lesser amount – or nothing at all – at the end of the performance period. It was this anomaly that triggered the SEC's December 2006 decision to require the reporting of equity award

amounts as they were earned (and recognized for financial reporting purposes) in the first place. Consequently, the change will take us back to where we were in August 2006, when the disclosure rules were initially adopted, without an obvious solution to the performance-based equity awards dilemma.

Interestingly, the return to full grant date fair value disclosure is not a foregone conclusion. In its Proposing Release, the SEC acknowledges that it has been presented with an alternative approach for disclosing equity awards that would involve the reporting of options and stock awards as they are realized. While the complexity of this approach may render it impractical (particularly in light of the complaints about the complexity of the current rule), it appears to signify that the SEC is receptive to considering other approaches to the extent that they produce clear, useful disclosure for investors.

As proposed, the change will likely eliminate the use of "alternative" SCTs which have proliferated since the adoption of the executive compensation disclosure rules. While it is expected that some companies will continue to employ the disclosure enhancement we saw during the 2009 proxy season in which companies contrasted the economic value of their outstanding equity awards with the awards' reported "accounting" value, we expect that compensation committees will be less inclined to develop entire "alternative" tables to explain how they viewed their named executive officers' total compensation packages.

In conjunction with the proposed change to the SCT, the proposal would also eliminate the grant date fair value information in the Grants of Plan-Based Awards Table. However, it's possible that investors will object to this change. As it now stands, the fair value information provided in this latter table is reported on a grant-by-grant basis, while the SCT information would be reported on an aggregate basis. Given the interest in these equity award amounts, we believe that, ultimately, the SEC will decide to retain this disclosure at the behest of investors.



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While the SEC has not settled on a specific transition method if it ultimately adopts its proposed amendment, it is considering an approach that would require companies to recalculate the equity award values (and total compensation figures) for their 2009 named executive officers using the new methodology for fiscal 2007 and 2008. Nonetheless, it is soliciting comment on whether this would create any practical complications and, if so, what alternative transition method would be preferable.

### Compensation Consultant Disclosure

In 2006, the SEC was criticized for not requiring more specific disclosure about the relationship to the company of consultants that advise the board of directors on executive and director compensation matters. While currently companies are required to identify any consultant that is involved in determining or recommending executive or director pay, identify who engaged the consultant, and describe the nature and scope of the consultant's assignment, no information is required about the consultant's fee arrangements.

To rectify this oversight, and to highlight potential conflicts of interest, the SEC is proposing that companies be required to provide additional disclosure about any compensation consultants (or their affiliates) that are involved in assisting companies, or their boards of directors, in determining or recommending executive or director compensation. As proposed, where a compensation consultant (or any of its affiliates) played a role in determining or recommending executive and director compensation and also provided additional services to the company, the company would be required to disclose:

- the nature and the extent of all additional services provided;
- the aggregate fees paid to the consultant for its executive or director compensation services; and
- the aggregate fees paid to the consultant for the additional (non-compensation-related) services.

In addition, the company would be required to disclose whether the decision to engage the compensation consultant (or its affiliate) to perform the other (non-compensation-related) services was made, subject to screening, or recommended, by management, and whether the board of directors or the board compensation committee approved the provision of these services.

*Observations.* While it was widely expected that the SEC would enhance the disclosure about compensation consultants, it is surprising that the proposal was so narrow. For example, no fee disclosure is required about a consultant that has an engagement limited solely to providing executive compensation-related services. While the proposal does not define what constitutes "additional services," it is likely to include, among other things, benefits administration, human resources consulting, and actuarial services.

In addition, the proposal would also make clear that no consultant disclosure is required at all if the consultant's role is limited solely to working on a broad-based, non-discriminatory plan that is available generally to all salaried employees. Under the rules, such work is not considered "executive" compensation consulting that triggers the SEC's disclosure requirements.

### Annual Meeting Voting Results

The SEC is proposing to accelerate the timing as to when companies must disclose the voting results from their annual meeting of security holders. Currently, companies must disclose these results in the quarterly report on Form 10-Q for the fiscal quarter in which the annual meeting takes place. Consequently, it can be as long as three to four months following the meeting before the formal vote counts are publicly disclosed. Under the proposal, voting results would have to be disclosed in a current report on Form 8-K within four business days after the annual meeting. In the case of a contested election, where the voting results are not finalized with the required four business days, the preliminary voting results would be reported in the Form 8-K.



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### Enhanced Director and Director-Nominee Disclosure

The SEC is proposing that companies be required to provide additional background information about their existing corporate directors and any director-nominees (whether nominated by management or a shareholder). As proposed, companies would have to disclose the following new items:

- each individual's specific experience, qualifications, attributes, or skills that qualify him or her to serve as a director at the time that the disclosure is made, and as a member of any committee that the individual serves on or is chosen to serve on (if known), in light of the company's business and structure; and
- if material, the disclosure should cover more than the past five years, and include information about the individual's risk assessment skills, particular areas of expertise, or other relevant qualifications (such as past experience) as well as an explanation as to why this individual's service as a director would benefit the company

In addition, companies would be required to expand their disclosure of any directorships held by each director (and director-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, rather than just five, years.

*Observations.* While this proposal hasn't received the attention of the compensation disclosure proposals, it may turn out to be just as important given the changes that are underway in determining the composition of boards of directors. Although there is no requirement that directors possess specific skills or expertise to serve on the board or a board committee, the proposal will likely put pressure on boards to view their directors (or director-nominees) in purely quantitative terms (for example, ensuring that the members of the audit committee all have accounting backgrounds or experi-

ence). Individuals with sharp analytical skills (or simply an abundance of common sense), but without specific skills or knowledge, may find themselves more closely scrutinized for suitability to hold their positions.

In addition, it's unclear whether a requirement to provide this information annually will lead to generalized, "boilerplate" disclosure that will make proxy statements longer, but contribute little to investors' understanding of director qualifications. A more practical approach would involve simply requiring this enhanced disclosure when an individual is first elected to the board (or appointed to a board committee), when his or her background is relevant to an investor's evaluation of the individual's suitability to serve as a director or committee member.

### Company Leadership Structure

The SEC is proposing that companies be required to describe their leadership structure in their proxy statements. Specifically, this would involve disclosing whether:

- the same person serves as both principal executive officer and chairman of the board of directors; or
- two individuals serve in those positions.

If a single person serves as both principal executive officer and chairman of the board, a company would be required to disclose whether it has a lead independent director and describe the specific role that he or she plays in the leadership of the company. Most importantly, the company would be required to justify its leadership structure; specifically, explaining why it believes that its preferred structure is appropriate given its specific characteristics or circumstances.

*Observations.* While ostensibly just a disclosure requirement, it's apparent that the SEC is responding to investor complaints about the efficacy of consolidating the chairman and CEO positions. In particular, the requirement to justify its leadership structure will place the spotlight squarely on companies with a chairman-



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CEO and may accelerate the trend towards separating these positions. At the same time, the proposal is crafted so as to enable companies with unique circumstances to defend and explain their leadership structure; which will enable investors to better understand the rationale behind these arrangements.

### Other Possible Changes

While not the subject of formal proposals, the SEC is also soliciting comment on other ways to improve proxy statement disclosure, particularly with regard to executive compensation matters. Specifically, the SEC is seeking input on the following subjects:

- whether to require disclosure of the compensation paid to each executive officer, not just the named executive officers;
- whether to eliminate the exception that permits a company to omit performance target levels from its Compensation Discussion and Analysis based on the potential adverse competitive effect that would result from the disclosure;
- whether to require disclosure of whether or not a company has "hold to retirement" or "clawback" policies in place and, if not, why not;
- whether to require disclosure regarding 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;
- whether to require disclosure of the total number of compensation plans a company has and the total number of variables in all of its compensation plans; and
- with respect to "tax gross-up" arrangements for named executive officers, whether to require disclosure and quantification of the savings to each executive.

### What's Next?

The SEC is soliciting comments on these proposals until September 15, 2009. We expect swift adoption of final rules thereafter to allow adequate time for companies to integrate the new requirements into their proxy preparation processes in time for the 2010 proxy season.

While the final language of the proposals could (and almost inevitably will) change, their ultimate objectives have been established. Consequently, companies should begin preparing now for the revised disclosure requirements; particularly, the risk assessment requirement. In this regard, companies should;

- identify their current risk profile and review any attendant documentation that assesses the potential consequences of those risks;
- review their existing compensation plans and arrangements, with an emphasis on variations between different groups of employees and business units;
- identify any program features that could potentially unduly influence behavior, and determine whether appropriate safeguards or mitigation measures exist; and
- assess both individually and collectively the potential impact of these risks on the company's financial and business operations.

### Need Additional Assistance?

Compensia has had significant experience in helping technology and life sciences companies in preparing their executive compensation and other proxy statement disclosure. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in assessing how the SEC's proposals are likely to affect your executive compensation disclosure, please feel free to contact us. ■



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