



Proposed Changes to Disclosure Rules: Plan Now to Avoid the Unexpected

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INTRODUCTION

On July 10, 2009, the Securities and Exchange Commission released its proposals for a number of changes to the compensation disclosure and proxy rules.¹ The SEC believes that the proposed changes would enhance disclosure regarding compensation and corporate governance and clarify certain of the rules governing proxy solicitation. Although the comment process may result in some revisions to the proposals, the SEC expects the changes to be effective for the 2010 proxy season. Many of the proposed changes do not seem dramatic at first glance, but they could lead to surprising results. Therefore, companies should consider carefully the ramifications of the proposed changes now to avoid unpleasant surprises next year.

The proposed changes include:

- new Compensation Discussion and Analysis disclosure regarding compensation policies and practices that may increase risks;
- revised treatment of equity awards in the Summary Compensation Table and the Director Compensation Table;
- additional biographical disclosure about directors, nominees and executive officers and a discussion of director and nominee qualifications to serve as directors and members of board committees;
- new disclosure about board leadership structure and the role of directors in risk management;
- additional disclosure about compensation consultants that are not independent;
- accelerated reporting of voting results; and
- clarifications to the proxy solicitation rules.

¹ Proposed Rule: Proxy Disclosure and Solicitation Enhancements, Exchange Act Rel. No. 34-60280 (July 10, 2009), available at <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>. Comments about the proposed changes must be submitted to the SEC by September 15, 2009.

Taking concrete steps now to prepare thoughtfully for compliance with the proposed rules may help the preparation of next year's proxy statement and annual report on Form 10-K run more smoothly. The proposed changes may be adopted near the commencement of the 2010 proxy season and may require significant changes to the proxy statement or Form 10-K disclosures that companies have made in prior years. Accordingly, we advise companies not to wait until the final rules are adopted to assess their implications and begin to prepare the likely proxy statement or Form 10-K disclosures. Moreover, many of the proposed changes will be of interest to, and require input from, senior management and members of the board of directors.

Proposed Amendments

I. Inclusion of Risk in Compensation Discussion and Analysis

The SEC's proposed changes would require Compensation Discussion and Analysis (CD&A) to include an examination of a company's compensation policies and practices for employees generally, including employees who are not executive officers, if risks arising from those policies or practices may have a material effect on the company. This change would represent the first expansion of the scope of CD&A beyond named executive officers to cover compensation for all employees. The SEC believes that such disclosure can assist stockholders in determining whether a company's compensation programs incentivize employees to take excessive or inappropriate risks.² Even if a company concludes that its compensation policies and practices do not result in risks that could have a material effect on the company, it may elect to include an affirmative statement in CD&A that the company's overall compensation structure does not affect its risk profile. A company may, in some cases, wish to support such an affirmative statement by discussing the aspects of compensation that the compensation committee reviewed in concluding that the company's compensation policies and practices do not create any material risks.

Although problems in the financial sector may have prompted the proposed changes, the concept of risk for purposes of CD&A is broadly defined to encompass strategic and other long-term business risks as well as short-term risks such as from proprietary trading desks at financial institutions. The application of materiality standards in this context may require difficult judgments. Business units responsible for a disproportionate share of the company's risk profile, that have different compensation structures, higher compensation expenses or greater profitability than other business units, or that have risk and reward structures that differ meaningfully from other units within the company could trigger additional CD&A disclosure requirements.

The proposed change to CD&A would force directors and management to review current compensatory policies and practices for all employees to determine whether they could have a

² The proposed rule provides examples of issues that companies may need to address for the business units or employees discussed depending on the company's specific circumstances.

material effect on the company's risk profile. The rule would effectively impose an affirmative obligation to conduct this analysis in connection with CD&A preparation regardless of the degree to which directors or management actually considered such factors at the time they made compensation decisions.

Possible Action Items:

- Assess compensation policies and practices for all employees and consider whether additional CD&A disclosure will be necessary.
- Review with the compensation committee the effects that the proposed changes to the compensation disclosure rules would have on the company's next proxy statement or Form 10-K in advance of the sessions ordinarily scheduled to review these annual disclosures.

II. Revisions to Treatment of Equity Awards in Summary Compensation Table and Director Compensation Table

The proposed amendments to the compensation disclosure rules would alter the treatment of equity awards in the Summary Compensation Table and the Director Compensation Table. In the Stock Awards and Option Awards columns of those tables, the aggregate grant date fair value of awards computed in accordance with FAS 123R³ would replace the dollar amount recognized for financial statement reporting purposes for the fiscal year in accordance with FAS 123R.⁴ The SEC believes that this change will better align the identification of named executive officers with compensation decisions and will facilitate clearer CD&A discussion of compensation policies and decisions with respect to the last fiscal year.

The proposed changes may move compensation amounts from one year to another and affect the identity of named executive officers for the current year.⁵ Because the Summary Compensation Table reports named executive officer compensation for the last three completed fiscal years, the proposed changes create transition issues and will require the recalculation of compensation reported for prior years in ways that might differ substantially from the amounts

³ For periods ending on or after September 15, 2009, the Financial Accounting Standards Board (FASB) Accounting Standards Codification will supersede all references to previous FASB standards, such as FASB Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123R). Any final rules the SEC adopts will use updated references to accounting standards.

⁴ This change would eliminate the possibility of negative numbers appearing in the equity award columns.

⁵ As proposed, the rules may also require compensation for equity awards granted on the same date to be reported in different fiscal years depending on whether an executive officer or director elects to receive an equity award in lieu of salary, bonus or director fees.

that were previously reported in the Summary Compensation Table. Such differences are particularly likely when FAS 123R expense has been impacted by fluctuations in a company's stock price, the forfeiture of previously granted equity awards or the improbability of achieving performance targets.

Possible Action Items:

- Evaluate the impact of the proposed amendments on the individuals expected to constitute named executive officers for the current year.
- Create mock-ups of the Summary Compensation Table and the Director Compensation Table to anticipate the contents of the 2010 proxy statement or the Form 10-K for 2009.
- Notify senior management and compensation committee members of any significant expected changes so they are fully informed as they make compensation decisions during the remainder of the current fiscal year. The proposed changes would cause a large one-time equity grant to result in significantly greater compensation reported for the year of grant and, accordingly, could affect the composition of the named executive officer group.

III. Enhanced Biographical and Suitability Disclosure

Currently, the disclosure rules require only brief biographical information for the past five years about directors and nominees and general disclosure about director qualification requirements. The proposed amendments would also require the following:

- a discussion of each director's or nominee's experience, qualifications, attributes or risk assessment and other skills relevant to service as a director and to membership on board committees on which the person serves or will serve;
- disclosure of any directorships at public companies held by a director or nominee at any time during the past five years even if the individual no longer serves on such boards (rather than only current directorships); and
- disclosure of any legal proceedings⁶ involving a director, nominee or executive officer during the last ten years (rather than during the last five years).

⁶ Covered legal proceedings include such matters as bankruptcy filings, criminal convictions, pending criminal indictments and violations of Federal or State securities law.

Possible Action Items:

- Revise director and officer questionnaires to include questions that solicit the additional information the proposed rules would require.
- Circulate director and officer questionnaires earlier than usual in advance of the 2010 proxy season to avoid the last-minute discovery of issues that could create concerns.

IV. New Disclosure about Board Leadership Structure and Role in Risk Management

The proposed changes would require a company to:

- discuss the board's role in the risk management process, including, if relevant, the role of board committees, such as the audit committee, and whether and how risk management personnel report to the board; and
- disclose the board's leadership structure, explain why the company believes that leadership structure is appropriate given the circumstances and discuss whether and why the company has a combined or separate chief executive officer and board chair and whether it has a lead independent director.

Corporate governance activists have recently focused on board leadership structure and have submitted numerous stockholder proposals seeking to mandate an independent board chair so that the same person could not serve as chief executive officer and board chair. The Shareholder Bill of Rights Act of 2009, which is currently pending in Congress, would require the separation of the chief executive officer and board chair roles. The SEC took a neutral stance in proposing a requirement that a company disclose its leadership structure and the rationale for that structure. The proposing release acknowledges that there is no one preferred leadership structure that all companies ought to adopt and that separation of the chief executive officer and board chair positions may not always be desirable.

Possible Action Item:

- Commence internal discussions, including with directors if appropriate, regarding the rationale for the company's current board structure and the role of the board and relevant committees in risk management.

V. Additional Disclosure about Compensation Consultants

Proposed amendments to the disclosure rules would also require a company to disclose 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 and they also provide other services to the company. This enhanced disclosure would not be required if the

compensation consultant's role is limited to executive and director compensation or if the compensation consultant's only involvement in recommending the amount or form of executive or director compensation is in connection with broad-based plans, such as 401(k) plans or health insurance plans, that do not discriminate in favor of executive officers or directors of the company.⁷ Specifically, the proposed rules would require a company whose compensation consultant was not independent to disclose:

- the nature and extent of all additional services that the consultant or its affiliates has provided to the company or its affiliates during the last fiscal year;
- the aggregate fees paid for such additional services and the aggregate fees paid for determining or recommending the amount or form of executive and director compensation;
- whether the decision to engage the consultant for additional services beyond executive and director compensation was made, recommended, screened or reviewed by management; and
- whether the board or compensation committee has approved all such additional services provided by the consultant.

By requiring disclosure about compensation consultant fees only when consultants are not independent, the SEC is in effect taking a normative position that will likely accelerate the trend of compensation committees to rely only upon compensation consultants that provide no other services to the company.⁸ In comparison, the SEC requires disclosure of all fees paid to a company's auditors, regardless of whether such auditors also provide non-audit services to the company. We anticipate that the proposed changes will result in more companies including affirmative statements about compensation consultant independence in their proxy statement or Form 10-K disclosures.

⁷ The proposed rules also clarify that the existing disclosure requirements relating to the role of compensation consultants in executive compensation do not apply if the consultant's only role is in connection with such broad-based plans.

⁸ The Corporate and Financial Institution Compensation Fairness Act of 2009, which is based on a proposal by the Treasury Department and is expected to be introduced in Congress, would require (1) members of public company compensation committees to be independent (similar to existing requirements for audit committee members); (2) any compensation consultants and legal or other advisors hired by the compensation committee to be independent of management; and (3) company-provided funding for compensation committees to hire such independent advisors.

Possible Action Items:

- Identify and quantify all services that compensation consultants have provided to the company during the current fiscal year.
- Consider whether to change compensation consultant arrangements to eliminate any perceived conflicts of interest.

VI. Accelerated Reporting of Voting Results on Form 8-K

The SEC proposes to transfer the requirement to disclose annual and special meeting voting results from Form 10-Q or Form 10-K to Form 8-K. The proposed changes would require a company to disclose the results of a stockholder vote within four business days. For contested elections, preliminary voting results must be filed within four business days after the meeting if definitive results are not available, and an amended report on Form 8-K must be filed within four business days after final results have been certified.

Possible Action Items:

- Update disclosure controls and procedures to reflect this accelerated reporting requirement.
- Coordinate with the inspector of elections in advance of the annual or special meeting to make sure that tabulation of voting results will be completed in a timely manner.

VII. Clarifications to Proxy Solicitation Rules

The SEC's proposals relating to proxy solicitation would clarify the rules in the following ways:

- Rule 14a-2(b)(1) under the Securities Exchange Act of 1934 exempts from most proxy rule requirements solicitations by stockholders or other non-management parties who are not seeking proxy authority and do not have a substantial interest in the subject matter of the solicitation. This exemption is not available to persons who furnish, request, or act on behalf of a person who furnishes or requests, a form of revocation. The SEC proposal confirms that an unmarked copy of management's proxy card that the soliciting stockholder requests be returned directly to management does not constitute a form of revocation.

The foregoing exemption is not available to "[a]ny person who, because of a substantial interest in the subject matter of the solicitation, is likely to receive a benefit from successful solicitation that would not be shared pro rata by all other holders of the same class of securities, other than a benefit arising from the person's employment with the registrant." The proposed amendment expressly notes that this limitation is applicable to any person with a substantial interest as described in the rule even if the person is not a stockholder of the company and the substantial interest does not arise from ownership of securities of the company.

- Rule 14a-4(d)(1) requires that a bona fide nominee consent to being named in a soliciting person's proxy statement and to serving if elected. Rule 14a-4(d)(4) is an exception to the bona fide nominee requirement. The exception permits a person soliciting support of nominees for a minority of the board to round out its short slate of nominees by seeking authority to vote for nominees named in the company's proxy statement. Although the current rule expressly permits rounding out a short slate with nominees named in the company's proxy statement, it does not address nominees named in other soliciting persons' proxy statements. The proposed amendment explicitly allows a soliciting person to round out a short slate with nominees from the proxy statement of the company or any other soliciting person.
- Rule 14a-4(e) requires that a proxy statement or form of proxy provide that the shares represented by the proxy be voted subject to reasonable specified conditions. The SEC proposal clarifies that reasonable specified conditions must be objectively determinable so that a stockholder can make an informed and confirmable decision about whether to grant proxy authority.
- Rule 14a-12 permits a solicitation to be made before furnishing security holders with a proxy statement, if, among other requirements, each part of the solicitation that is written includes the identity of the participant in the solicitation and a description of that participant's direct or indirect interests, or includes a legend advising security holders where to find such information. The SEC proposal would clarify that information referred to in the legend must be filed with the SEC under cover of Schedule 14A as part of a proxy statement or other soliciting materials no later than the time the first soliciting communication is made.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

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