SEC Adopts Amended Rules for Compensation and Corporate Governance Disclosure

December 31, 2009

INTRODUCTION

On December 16, 2009, the Securities and Exchange Commission adopted amendments to its rules on compensation and corporate governance disclosure.[1] The SEC believes that the changes will enhance the information provided in annual reports and in proxy and information statements to better enable stockholders to evaluate the leadership of public companies.

Proxy statements and annual reports on Form 10-K must be in compliance with the new rules if (1) the company's fiscal year ends on or after December 20, 2009 and (2) the proxy statement or annual report is filed on or after February 28, 2010.[2] Registration statements for new registrants that are first filed on or after December 20, 2009 must be in compliance with the new rules in order for them to be declared effective on or after February 28, 2010.[3]

The changes include:

- new disclosure regarding compensation policies and practices that are reasonably likely to present material risks to the company;
- 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;
- new disclosure about board leadership structure and the role of the board in risk oversight;

---

1 Final Rule: Proxy Disclosure Enhancements, Exchange Act Rel. No. 34-61175 (December 16, 2009), available at http://sec.gov/rules/final/2009/33-9089.pdf.

2 Preliminary proxy statements filed before February 28, 2010 must also be in compliance with the new rules if the company expects to file the definitive proxy statement on or after that date. Companies that are not currently subject to the new rules are permitted to comply with any of the new rules voluntarily; however, companies may only adopt the revised Summary Compensation Table and Director Compensation Table disclosures if they comply with all of the new rules.

3 On December 22, 2009, the SEC Staff issued compliance and disclosure interpretations relating to transition issues for the new rules. These interpretations are available at http://sec.gov/divisions/corpfin/guidance/pdetinterp.htm.

- additional disclosure about compensation consultants that are not independent; and
- accelerated reporting of voting results.

As we previously noted at the time the revised rules were proposed (the "Proposed Rules"),[4] many of the changes will be of interest to, and require input from, senior management and members of the board of directors.

PRINCIPAL AMENDMENTS

I. New Disclosure of Compensation Policies and Practices That Present Material Risks

The SEC adopted a requirement that companies disclose compensation policies and practices for any employees if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company as a whole. 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.[5] The new rules effectively impose a continuing affirmative obligation on a company to conduct an analysis of whether its compensation policies and practices are reasonably likely to have a material adverse effect on the company in connection with the preparation of the proxy statement and Form 10-K, regardless of the degree to which directors or management actually considered such effect at the time they made compensation decisions.

As adopted, the new rules have a number of significant differences from the Proposed Rules:

- The disclosure threshold has been changed to "reasonably likely to have" from "may have," and the effect limited to a "material adverse effect" from any "material effect." The "reasonably likely" standard is the same standard as that currently applicable to certain disclosure required to be included in Management Discussion and Analysis (MD&A). MD&A currently requires risk-oriented disclosure of known trends and uncertainties that are material to the business.
- The revised disclosure threshold and limitation are also expressly intended to permit companies to consider compensating or offsetting steps or controls designed to limit risks of certain compensation arrangements.

[4] See our memorandum dated July 24, 2009 entitled "Proposed Changes to Disclosure Rules: Plan Now to Avoid the Unexpected," which is available upon request or at our website: www.simpsonthacher.com.

[5] The new rules provide examples of issues that companies may need to address for the business units or employees discussed depending on the company's specific circumstances.

- Disclosure would be provided in a separate section and not be part of Compensation Discussion and Analysis (CD&A).[6] CD&A is designed to provide a discussion and analysis of the compensation of the named executive officers and the information contained in the Summary Compensation Table and other required tables, while the new disclosure would cover all employees.

- The SEC has also stated that the new rules do not require a company to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

Although problems in the financial sector may have prompted the proposed changes, the concept of risk for purposes of this disclosure 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. 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 the new disclosure requirements.

Although we believe that the threshold for disclosure under the new rules has been significantly raised from that under the Proposed Rules, when a company operates in particular industries in which investors have heightened concerns regarding the effects of compensation policies and practices, even if no material adverse effect is reasonably likely, the company may wish to elect to include a discussion of the aspects of compensation that the compensation committee or board of directors reviewed in analyzing the company's compensation policies and practices.

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

The amendments to the compensation disclosure rules 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 made during the fiscal year, computed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 718, Compensation – Stock Compensation ("ASC Topic 718"),[7] replaces the amount of compensation expense recognized for financial statement

---

6 An analysis of how risk management policies or practices affect compensation for named executive officers would, however, still be part of CD&A if such policies or practices were a material factor in the determination of the forms or terms of compensation awarded to named executive officers.

7 For periods ending on or after September 15, 2009, ASC Topic 718 supersedes references to the previous standard, FASB Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ("FAS 123R").

reporting purposes for the fiscal year.[8] 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.

As adopted, the new rules differ from the Proposed Rules in several important respects:

- The full grant date fair value of each equity award granted during the fiscal year will continue to be required to be reported in the Grants of Plan-Based Awards Table and in a footnote to the Director Compensation Table. The aggregate of such values will, however, now be reported in the Stock Awards and Option Awards columns of the Summary Compensation Table and Director Compensation Table, respectively.

- For awards subject to performance conditions, the grant date fair value reported both in the aggregate and for each award should be based on the probable outcome of the performance conditions, determined as of the grant date. This amount should be consistent with the estimated aggregate compensation cost to be recognized over the relevant service periods in accordance with ASC Topic 718, excluding (as is currently the case) the effect of estimated forfeitures. The SEC believes that requiring disclosure to always be based on maximum performance would overstate the intended level of compensation and result in investor misinterpretation of compensation decisions, as well as discourage the use of awards with difficult (or any) performance conditions.[9]

- Notwithstanding the foregoing, footnotes will be required to the Summary Compensation Table and Directors Compensation Table disclosing the maximum aggregate value of stock awards and option awards assuming the highest level of performance is probable.[10]

- Upon adoption of the new equity award reporting rules, companies will also be required to recompute the Stock Awards, Option Awards and Total Compensation values for each of the prior fiscal years included in the Summary Compensation Table. The recomputed equity award values may differ from the aggregate of the grant date fair values previously reported in Grants of Plan-Based Awards Tables in prior years where awards in prior fiscal years were subject to performance conditions. As we previously noted, the recomputed amounts might differ substantially from the amounts that were reported in the Summary Compensation

---

8 Among other consequences, this change eliminates the possibility of negative numbers appearing in the equity award columns.

9 The SEC also noted that reporting award values in the tables based on maximum performance levels would lead to inflated compensation when equity awards or total compensation are benchmarked to levels reported at other companies.

10 This footnote disclosure may indirectly reveal how difficult it will be for executives or how likely it will be for the company to achieve maximum performance levels or other factors. Currently similar disclosure, in more general terms, is only required for undisclosed target levels in cases where a company determines that disclosure of actual target levels would cause competitive harm.

Table in prior years. Such differences are particularly likely when the previously reported accounting expense has been impacted by fluctuations in a company's stock price, the forfeiture of previously granted equity awards or the subsequent improbability of achieving performance targets.

As we previously noted, these changes may significantly change reported total compensation amounts and affect the identity of named executive officers for the current year.[11]

III. Enhanced Biographical and Suitability Disclosure

The SEC also adopted revised rules regarding biographical and related information about directors, nominees and executive officers. As adopted, the new rules have several differences from the Proposed Rules:

- The new rules require a discussion of each director's or nominee's experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director, but will not require similar discussion regarding suitability for membership on board committees on which the person serves or will serve.

- The new rules do not specify the particular information about directors and nominees that should be discussed, and references in the Proposed Rules to discussion of "risk assessment skills" have been deleted. The SEC notes, however, that if particular skills, such as risk assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director, this should be disclosed.

- The new rules also require disclosure of whether, and if so how, a nominating committee considers diversity[12] in identifying nominees for director. In addition, if the nominating committee or board of directors has a policy regarding any such consideration, disclosure would be required of how the policy is implemented, as well as how the committee or board assesses the effectiveness of its policy.

- In addition to extending the required disclosure of any legal proceedings involving a director, nominee or executive officer to those during the last ten years (rather than

---

11 The SEC did not adopt the Proposed Rule that would have changed the reporting treatment in cases in which an executive officer or director elects to receive an equity award in lieu of salary, bonus or director fees. The SEC also did not make any change with respect to the fiscal year in which the grant of an equity award is reported, even in cases where the award is made in respect of performance in a prior fiscal year.

12 Diversity is intentionally not defined in the new rules, and companies are allowed to define it in ways that they consider appropriate. As examples, companies may view diversity broadly to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, or may focus on concepts such as race, gender and national origin.

during the last five years), the new rules have also expanded the list of covered legal proceedings.[13]

As in the Proposed Rules, the new rules will also require 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).

As a result of the new rules, companies will need to revise director and officer questionnaires, or if they have already been circulated for the fiscal year, supplement such questionnaires, to include questions that solicit the additional information the new rules may require.

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

The SEC adopted, with few changes, the Proposed Rules which require a company to:

- discuss the board's role in the oversight of risk, including, if relevant, the role of board committees, such as the audit committee or a separate risk committee, and whether and how risk management personnel report to the board; and
- disclose the board's leadership structure, explain why the company believes its 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 and, if it does, his or her specific role.

As we previously noted, 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 SEC took a neutral stance in only adopting a requirement that a company disclose its leadership structure and the rationale for that structure. Both the SEC's proposing and final releases acknowledge that there is no one preferred leadership structure that all companies ought to adopt and that the new rules are not intended to influence a company's decision regarding its board leadership structure.

V. Additional Disclosure about Compensation Consultants

The SEC also adopted amendments to its disclosure rules that may 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 or director compensation and

---

[13] Covered legal proceedings had previously included such matters as bankruptcy filings, criminal convictions, pending criminal indictments and violations of Federal or State securities laws or Federal commodities laws. The expanded list of legal proceedings now also includes mail or wire fraud or fraud in connection with any business activity; violations of Federal or State commodities, banking or insurance laws, or any settlement to such actions; and disciplinary sanctions imposed by a stock, commodities or derivatives exchange or similar organization. Settlement of a civil proceeding among private parties, however, is expressly not included.

they also provide other non-executive compensation consulting services to the company or its affiliates.[14]

Specifically, the new rules require a company whose compensation consultant was not independent to disclose the aggregate fees paid during the last fiscal year to the consultant or its affiliates for determining or recommending the amount or form of executive or director compensation and the aggregate fees paid for all additional services to the company and its affiliates.

In addition, if fee disclosure is required and the consultant was engaged for executive or director compensation consulting services by the board of directors or compensation committee, the company must also disclose:

- whether the decision to engage the consultant for additional services beyond executive and director compensation was made or recommended by management; and
- whether the board or compensation committee has approved all additional non-executive consulting services provided by the consultant.[15]

The new rules, moreover, have several important exceptions to compensation consultant fee disclosure. Under the new rules, fee and other additional disclosure is not required:

- if the fees for the non-executive consulting services did not exceed $120,000 during the company's last fiscal year;
- 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; or if the consultant's services are limited to providing information, such as surveys, that either is not customized for a particular company or that is customized based on parameters that are not developed by the consultant;[16] and

---

[14] It is not clear whether, or the extent to which, the new rules would require disclosure of the fees paid for services provided by a compensation consultant or its affiliates to another company that is considered under common control with a company because they have related controlling shareholders.

[15] Unlike the Proposed Rules, the new rules do not require a discussion of the nature and extent of all additional non-executive consulting services. Companies may, however, at their discretion describe such services where such information would facilitate investor understanding of the existence or nature of any potential conflict of interest.

[16] The new rules also provide that the existing disclosure requirements relating to a discussion of 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 or providing such information.

- for consultants that work with management (whether for only executive compensation consulting services or for both executive compensation consulting and other non-executive consulting services) if the board of directors or compensation committee has its own independent 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. 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 changes will result in more companies including affirmative statements about compensation consultant independence in their proxy statement or Form 10-K disclosures.

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

The SEC adopted, with a few minor clarifications, its Proposed Rules that transfer the requirement to disclose annual and special meeting voting results from Form 10-Q or Form 10-K to Form 8-K. The changes require a company to disclose the results of a stockholder vote within four business days after the end of the meeting. 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 are known.

* * *

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 memoranda regarding recent corporate reporting and governance developments, can be obtained from our website, www.simpsonthacher.com.

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Tower One
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

LATIN AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
12th Floor, Suite 121
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000