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SEC Adopts Changes to Compensation Disclosure Rules

On December 16, 2009, the SEC amended its rules to enhance disclosure regarding executive and director compensation, director and director nominee qualifications, corporate governance issues and the results of shareholder votes. We highlight below the new requirements that relate to executive and director compensation.

In summary, the compensation disclosure amendments will require:

- a discussion of a company's policies and practices of compensating its employees, including non-executive officers, as they relate to risk management and risk-taking incentives, if risks arising from such policies and practices are "reasonably likely to have a material adverse effect on the company;" and
- the aggregate grant date fair value of stock and option awards granted during a fiscal year to be reported in the Summary Compensation Table and Director Compensation Table, rather than the amount recognized for financial statement reporting purposes.

Our alert highlighting changes to the disclosure requirements related to board structure, director and director nominee qualifications and other corporate governance issues and compensation consultants will be distributed separately and will also be available at www.paulweiss.com.

Effective Date

The effective date for the new rules is February 28, 2010 (the "Effective Date"). The SEC recently released Compliance and Disclosure Interpretations that set forth interpretations of how the Effective Date applies to SEC filings at or around the time of the Effective Date. See http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm.

A company with a 2009 fiscal year that ends on or after December 20, 2009 must comply with the new disclosure rules for Form 10-Ks and proxy statements filed on or after the Effective Date. If the company is required to file a preliminary proxy statement and expects to file its definitive proxy statement on or after the Effective Date, the preliminary proxy statement must comply with the new disclosure rules, even if the preliminary proxy statement is filed before the Effective Date. If the company files its 2009 Form 10-K before the Effective Date and its proxy statement on or after the Effective Date, the proxy statement must also comply with the new disclosure rules.

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A company with a 2009 fiscal year that ends before December 20, 2009 is not required to comply with the new disclosure rules in respect of its 2009 Form 10-K or related proxy statement, even if either is filed on or after the Effective Date. A company that is not required to comply with the new rules for its 2009 Form 10-K and proxy statement may voluntarily comply, but if it complies with the Summary Compensation Table and Director Compensation Table amendments, it must comply with all of the other amendments to Regulation S-K. The interpretations specify that a company may voluntarily comply with the new disclosure requirements (other than the changes to the Summary Compensation Table and Director Compensation Table amendments) without having to comply with all of the other new disclosure rules. Similarly, registration statements for a reporting company with a 2009 fiscal year that ends before December 20, 2009 will not need to comply with the new disclosure rules.

A new registrant that first files a registration statement on or after December 20, 2009 must comply with the new disclosure rules for any registration statement to be declared effective on or after the Effective Date.

Disclosure of Compensation Policies and Practices as they Relate to Risk Management

The rules add a new paragraph (s) to Item 402 of Regulation S-K, which requires companies to disclose, for *all* employees, and not just the "named executive officers" (i.e., the CEO, CFO and the next three most highly compensated executive officers), the compensation policies and practices for such employees if such policies and practices create risks that are reasonably likely to have a material adverse effect on the company. The placement of the disclosure is a change from the original proposal, which would have required the disclosure to be part of the Compensation Discussion and Analysis ("CD&A"). The SEC was persuaded by commenters that it would be potentially confusing to expand the CD&A beyond the named executive officers. The adopting release notes that this disclosure is separate from, and in addition to, the existing requirement to discuss, as part of the CD&A, the relationship of risk to compensation to the extent risk considerations are a material aspect of a company's compensation policies or decisions for named executive officers. Smaller reporting companies will not be required to provide the new Item 402(s) disclosure.

The disclosure threshold in the new rule (i.e., "reasonably likely" to have a "material adverse effect") is a higher standard than under the proposed rule, which would have required disclosure where risks arising from compensation policies or practices "may have a material effect on" the company. In explaining the reasons for adoption of this standard in the final rule, the SEC notes that companies are familiar with the "reasonably likely" disclosure threshold because it is applied for purposes of the Management Discussion and Analysis ("MD&A"). The MD&A requires risk-oriented disclosure of known trends and uncertainties that are material to the business, so using the same threshold for risk-related disclosure in new Item 402(s) parallels this MD&A requirement. The threshold is also intended to address concerns by commenters that companies could not, under the proposed rule, consider offsetting steps or controls designed to limit risks in compensation arrangements. Under the new rule, companies may take such factors into account in determining whether risks arising from compensation policies and practices are reasonably likely to have a material adverse effect on the company "as a whole." For example, if compensation practices for some groups mitigate or balance risky incentives in place for other groups, the company may determine that they are not reasonably likely to have a material adverse effect on the company as a whole.

The SEC indicated in the adopting release that the lower standard in the proposed rule could have resulted in voluminous disclosure that was insignificant and burdensome to shareholders by companies simply intending to comply with the rule. The use of the revised standard is intended to elicit disclosure of only those compensation practices and policies that would be most relevant to investors. In addition, by requiring disclosure of only policies and practices that have a material "adverse" effect, the SEC seeks to avoid unnecessary disclosure of inapplicable compensation arrangements.

The adopting release provides that the situations requiring disclosure will vary depending on the particular company and its compensation programs. The SEC did provide (as had been proposed) a non-exclusive list of situations where compensation policies and practices could potentially raise material risks to the company, including compensation policies and practices:

- at a business unit of the company that carries a significant portion of the company's risk profile;
- at a business unit with compensation structured significantly differently than other units within the company;
- at a business unit that is significantly more profitable than others within the company;
- at a business unit where the compensation expense is a significant percentage of the unit's revenues; and
- 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 SEC notes, however, that, even in the above listed situations, a company could conclude that its compensation policies and practices are not reasonably likely to have a material adverse effect. It notes further that there may be other features of a company's compensation policies and practices that have the potential to incentivize employees to take risks that are reasonably likely to have a material adverse effect on the company.

The new rule also adopts as proposed the following illustrative examples of issues that would potentially be appropriate for a company to address, if the company determines that disclosure is required:

- the general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by employees on behalf of the company, and the manner of implementation;
- the company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;
- how the company's compensation policies and practices 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 clawbacks or imposing holding periods;
- the company's policies regarding adjustments to its compensation policies and practices to address 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 its employees.

In the adopting release, the SEC characterizes this as a principles-based approach, similar to the approach taken with respect to the CD&A requirements, and intends that the above examples help companies identify the types of disclosure that may be applicable. The examples are non-exclusive, and application should be tailored to a company's facts and circumstances.

The release specifically provides that the SEC would not expect to see generic or boilerplate disclosure that the incentives are designed to have a positive effect or that compensation levels may not be sufficient to attract or retain employees with appropriate skills in order to enable the company to maintain or expand operations.

Importantly, companies will <u>not</u> be required to make an affirmative statement that they have determined that the risks arising from their compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

Summary Compensation Table and Director Compensation Table

Stock and Option Awards

The SEC has revised the amounts required to be disclosed in the Summary Compensation Table and Director Compensation Table for stock and option awards to named executive officers and directors. Under the new rule, the aggregate grant date fair value of stock and option awards granted to named executive officers and directors during the fiscal year, computed in compliance with Financial Accounting Standards Board Codification Topic 718, will be required to be disclosed in the Summary Compensation Table and Director Compensation Table, replacing the current requirement to disclose in those tables the applicable accounting expense (i.e., the dollar amount recognized for financial statement reporting purposes under FAS 123R in such fiscal year).[1] The full grant date fair value of each equity award will still be reported in the Grants of Plan-Based Awards Table and the Director Compensation Table. Under the proposed rule this disclosure would have been eliminated.

In the adopting release, the SEC noted it is persuaded that disclosure of the aggregate grant date fair value better reflects compensation committee decisions regarding stock and option awards. The SEC acknowledged that in certain cases the revised disclosure requirement could result in one or more individuals who would otherwise be expected to be named executive officers not being required to be disclosed in the Summary Compensation Table because of, for example, the receipt of large "one time" multi-year grants. Nonetheless, the SEC remains of the view that it is more meaningful to shareholders to include this disclosure of grant date value even if this causes the named executive officers to change. The adopting release provides that, where such a large "new hire" or "retention" grant results in the omission from the Summary Compensation Table of another executive officer, the company may consider including additional compensation disclosure for that executive officer to supplement the required disclosures.

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[1] The SEC notes in the adopting release that it is updating the references in the adopting release and the new rules to reflect that the Financial Accounting Standards Board Accounting Standards Codification has superseded all references to previously FASB standards for interim or annual periods ending on or after September 15, 2009.

For performance awards, the new rules require companies to disclose the grant date value in the Summary Compensation Table, Grants of Plan-Based Awards Table and Director Compensation Table based on the probable outcome of the performance conditions. The SEC indicates that this value should be a better reflection of how performance contingent vesting conditions are taken into account by the compensation committee in granting such awards. New instructions to the rules clarify that this amount will be consistent with the grant date estimate of compensation cost to be recognized over the service period, excluding the effect of forfeitures. However, companies must disclose the maximum potential value of the performance award in a footnote to the applicable table.

In the adopting release accompanying the previously proposed rules, the SEC had requested comments on whether it would be more appropriate in certain circumstances to require disclosure of awards granted *for services* in the relevant fiscal year, even if granted after fiscal year end, rather than awards granted *during* the relevant fiscal year, as proposed. The SEC decided to retain the requirement to disclose stock and option awards granted *during* the relevant fiscal year, because many subjective factors that vary from company to company influence the granting of awards after a fiscal year end, and to require disclosure based on the year of services could erode comparability of compensation among companies. The adopting release provides that companies should continue to analyze their decisions to grant post-fiscal year end equity awards in the CD&A where those decisions could affect a fair understanding of named executive officers' compensation for the last fiscal year, and should consider including supplemental tabular disclosure, when necessary, if it helps investors understand the CD&A.

Transition Issues. Companies providing Item 402 disclosure for a fiscal year ending on or after December 20, 2009 will be required to recompute the stock and option awards disclosure in the Summary Compensation Table for each preceding fiscal year required to be included in the table (even where an executive officer was in the table in 2007 and 2009 but not in 2008) and to recompute the total compensation column based on these revisions. The stock and option award column amounts should be computed based on the individual award grant date values reported in the applicable year's Grants of Plan-Based Awards Table, except that awards with performance conditions should be recomputed to report grant date fair value based on the probable outcome as of the grant date. However, companies will not be required to include different named executive officers for any preceding fiscal year or amend prior years' Item 402 disclosure included in previously filed Forms 10-K or other filings.

Forgone Salary and Bonus Disclosure Change Not Adopted

The SEC did not adopt its proposed revision to Instruction 2 to the salary and bonus column of the Summary Compensation Table, which would have provided that companies would not be required to report in those columns the amount of salary or bonus forgone at a named executive officer's election and that the non-cash awards received instead of salary or bonus would be reported in the column applicable to the form of award elected. Companies will continue to report the forgone amounts in the salary or bonus column, with footnote disclosure of the receipt of non-cash compensation that refers to the Grants of Plan-Based Awards Table where the stock, option or non-equity incentive plan award the named executive officer elected is reported.

The adopting release notes that the revision was not adopted because under the current rule investors receive disclosure that helps them understand the overall compensation strategy and the intended distribution of risk among different types of compensation. The SEC agreed with commenters that disclosing the amounts of salary and bonus that the compensation committee awarded better enables investors to understand the relative weights the company applied to annual incentives and salary.

Other Compensation Disclosure Initiatives

In its proposed rule, the SEC requested comments on a variety of other executive compensation disclosure initiatives, including on the annual change in value of stock and option awards, but decided not to adopt any other changes, consistent with its goal of adopting discrete amendments to improve compensation disclosure in proxy statements that could be implemented for the 2010 proxy season.

In a footnote, however, the SEC indicated that it would not object if companies voluntarily add a column captioned "Value of unexercised in-the-money options/SARs at fiscal year end ($)" to the Outstanding Awards at Fiscal Year-End Table to report fiscal year end intrinsic values.

Implications

Although these amendments will not be effective until late February, given the relatively short timeframe, it is important that companies that have not already done so (based on the remarks of the SEC chairman last summer and the proposing release issued in July) consider the scope of the additional information that will now be required, in particular relating to an analysis of their compensation policies and practices for all employees (not just the named executive officers), and whether such policies and practices have the potential to incentivize employees to take risks that are reasonably likely to have a material adverse effect on the company.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Any questions concerning the issues addressed in this memorandum may be directed to Mark S. Bergman (+44-207-367-1601), Raphael M. Russo (212-373-3309), Lawrence I. Witdorchic (212-373-3237) or Erin Murphy (212-373-3106).