

Authors:**Corporate/Securities:****Phillip J. Kardis II**

phillip.kardis@klgates.com
+1.202.778.9401

Vincent J. Pisano

vince.pisano@klgates.com
+1.212.536.4810

Executive Compensation:**Douglas J. Ellis**

douglas.ellis@klgates.com
+1.412.355.8375

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SEC Adopts Amendments to the Proxy Rules Concerning Disclosure of Executive Compensation and Corporate Governance

On December 16, 2009, the Securities and Exchange Commission (the “SEC”) adopted amendments (the “Amendments”) to its executive compensation and corporate governance disclosure requirements.¹ The Amendments are effective on February 28, 2010. Accordingly, many public companies face significant new disclosure requirements for the 2010 proxy season. Specifically, public companies now must begin considering new or expanded discussion of:

- Compensation policies for all employees that may present material risks.
- Stock option and other equity awards for named officers and directors.
- Director and nominee qualifications.
- Board leadership structure and role in risk oversight.
- Compensation consultants.
- Accelerated Reporting of Shareholder Votes on Form 8-K.

Compensation Policies and Risk

The Amendments require a new narrative disclosure that describes how the company’s overall compensation policies and practices create incentives that affect the company’s risk and management of risk.² Most of the compensation disclosures in a proxy statement relate only to a company’s Chief Executive Officer, its Chief Financial Officer, and its three highest paid executive officers other than the CEO and the CFO, also referred to collectively as the “named executive officers.” However, the discussion of the extent to which compensation creates incentives to expose the company to risks will apply to all employees if the risks arising from such policies and practices “are reasonably likely to have a material adverse effect on the company”.³ To avoid confusion with the discussion of named executive officer compensation, this new discussion will not be included in the Compensation Discussion and Analysis but rather as a separate stand-alone disclosure within the compensation disclosures.

¹ The adopting release, Securities Act Release No. 33-9089 (December 16, 2009), is available at <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

² Smaller reporting companies are not required to provide this new disclosure.

³ The Amendments differ from the proposed rules, Securities Act Release No. 33-9052 (July 10, 2009) (the “Proposed Rules”), by adding a “reasonably likely” threshold to the disclosure and limiting the disclosure to those risks reasonably likely to have a material “adverse” effect rather than any material effect.

The SEC has provided a non-exclusive list of situations where compensation programs may have the potential to raise material risks and thereby trigger this new disclosure requirement, such as compensation policies regarding particular business units that carry a significant portion of a company's risk profile, have compensation structured significantly differently from the company's general compensation policies, have compensation expense that is a significant percentage of the unit's revenues, or are significantly more profitable than other of the company's business units.

The SEC recognizes that this new disclosure will vary from company to company based on a variety of business and compensation philosophy factors. Nevertheless, it has provided examples of issues that may need to be addressed, including:

- The general design and implementation of the company's compensation policies and how such policies relate to or affect risk-taking by employees.
- The consideration, if any, given to risk assessment and risk-taking incentives in structuring the company's compensation policies or in awarding and paying compensation.
- How the compensation policies relate to realization of risks resulting from actions of employees in the short term or the long term, such as through clawbacks or required holding periods.

While some companies may already have considered risk with respect to certain aspects of their incentive compensation arrangements for named executive officers, it is likely that few companies have addressed risk throughout their compensation arrangements. Consequently, compliance will likely require a comprehensive risk analysis of a company's compensation structure throughout its entire organization.

Reporting of Equity Awards

The Amendments change the way compensation related to stock options, restricted stock and other equity grants is reported in the Summary Compensation Table by returning to the reporting approach originally proposed in 2006. Currently, the

Summary Compensation Table reflects the expense attributable to equity awards in the applicable fiscal year in accordance with GAAP (FAS 123(R)) rather than the grant date fair value of awards made during the year. The SEC appears to have recognized the distorting effect of showing the GAAP cost chargeable to a fiscal year. Accordingly, the Amendments require companies to report equity awards as compensation on the basis of their full aggregate grant date fair value computed in accordance with FAS 123R (which has been redesignated and is referred to in the Amendments as FASB Accounting Standards Codification Topic 718).

Also, the Amendments require that the value of performance-based awards be based on the "probable outcome of such conditions(s)." Footnote disclosure is required to show the "value of the performance-based award assuming that the highest level of performance will be achieved if an amount less than the maximum was included in the table." In the Grants of Plan-Based Awards Table, companies are required to continue to reflect the grant date fair value of individual equity awards, but will need to show performance-based grants on the revised basis.

This new manner of disclosure applies to all disclosures made after December 20, 2009 and will be required for awards made in prior years. That is, amounts in the Summary Compensation Table will need to be recomputed for prior years, but the recomputations are for informational purposes only and do not require the company to change the individuals reported as its named executive officers for any preceding year or amend any earlier filing.⁴ However, including the full grant date value of 2009 stock awards as compensation may significantly impact the determination of a company's named executive officers for proxy reporting purposes.

⁴ The Proposed Rules contained a proposal that salary or bonus foregone at the named executive officer's election in exchange for equity or other non-cash based awards would not be reported in the respective salary or bonus column. That proposal was not adopted.

Director and Nominee Qualifications

The Amendments significantly increase the disclosure about directors and nominees required in a company's proxy statement. Currently, disclosure covers only the individual's biography, including business experience over the past five years, current directorships and certain legal proceedings for the past five years. The Amendments require the following additional information:

- A statement as to each director and nominee about "the particular experience, qualifications, attributes or skills" that led the board to conclude that the person should serve as a director.⁵
- A list of all public company directorships the director or nominee has held during the preceding five years.
- Specified legal proceedings involving directors, executive officers or nominees will have to be reported if they occurred within the last ten years rather than five years and the list of proceedings subject to disclosure is greatly expanded to include mail or wire fraud, fraud in connection with any business entity, violations of any securities, commodities, insurance or banking laws, and disciplinary sanctions imposed by any exchange or other self-regulatory organization.

In addition, the Amendments require a company to disclose whether, and if so, how its nominating committee considers diversity in identifying director nominees. Also, if the company has a nominee diversity policy, the company will be required to disclose how the policy is implemented and how the committee assesses the policy's effectiveness. Each reporting entity is free to define diversity in its own way and may include, for example, geographic diversity, educational background or individual qualities it deems important.

⁵ The proposed requirement that information should be provided about the person's risk assessment skills was not adopted. The SEC did note, however, that such information should be disclosed if it was part of what led the board to reach its conclusion that the person should serve as a director.

Director and officer questionnaires will need to be updated or supplemented to request this new information and companies should consider implementing, or review their existing, diversity policies regarding director nominations in light of the new requirements.

Board Leadership Structure and Role in Risk Oversight

The Amendments require a company to discuss in its proxy statement its leadership structure and why the company believes that its structure is the best or most appropriate. In particular, a company is required to disclose whether and why it has combined or separated the functions of chief executive officer and chairman of the board, whether and why it has a lead independent director, and the specific role played by a lead independent director in the leadership of the company.

The Amendments also require a company to describe the board's role in risk oversight, how the board administers its oversight function, and the effect this has on the company's leadership structure. The examples of risk that the SEC has in mind include credit risk, liquidity risk and operational risk. The disclosure may also include whether the board as a whole considers these risks or if the board implements risk oversight through committees and whether the employees who oversee risk management report directly to the board or a committee.

Compensation Consultant Disclosure

Currently, a company is required to disclose in its proxy statement the role played by compensation consultants in recommending the amount or form of compensation to executives or directors. The Amendments expand the required disclosure if the consultant provided additional services to the company and the fees paid to the consultant for such additional services were in excess of \$120,000

during the company's last fiscal year.⁶ The expanded disclosure includes:

- The aggregate fees paid for all additional, non-executive compensation services provided by the compensation consultant to it or to its affiliates.
- The aggregate fees paid for determining executive officer and director compensation.
- In the case of a compensation consultant engaged by the compensation committee, whether the decision to engage the consultant for non-executive compensation work was made or recommended by management.
- Whether the compensation committee or the board approved these other services.

The disclosure requirements do not apply when the compensation consultant's only role in recommending the amount or form of executive or director compensation is in connection with consulting on broad-based plans that do not discriminate in favor of executive officers or directors of the company or where the consultant's

services are limited to providing information, such as survey data, that either is not customized for a particular company, or that is customized based on parameters that are not developed by the compensation consultant and about which the consultant does not provide advice.⁷

Accelerated Reporting of Shareholder Votes on Form 8-K

Currently, public companies disclose the result of any matter that was submitted to a shareholder vote at an annual or special meeting in the Form 10-Q for the fiscal quarter in which the shareholder meeting occurred or, if the meeting occurred during the fourth fiscal quarter, in the Form 10-K. The Amendments require the results of any shareholder vote to be disclosed in a Current Report on Form 8-K within four business days after the date of the meeting at which the vote was held. This disclosure applies even in most cases where the voting results may not be known within the four-day reporting period. In those instances, the company must report preliminary voting results and then amend the Form 8-K once the final results are determined.

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⁶ The augmented disclosure is required whether the board or management retained the compensation consultant. The additional disclosure is not required if the board has engaged a compensation consultant exclusively to provide consulting services to the board and management has engaged its own compensation consultant, even if management's consultant provides other services to the company.

⁷ The provision in the Proposed Rules requiring disclosure of the nature and extent of additional services provided by the compensation consultant was not adopted.