SEC and Treasury Propose New Executive Compensation Requirements

This e-Alert summarizes the rules proposed by the SEC on July 12 expanding the disclosure requirements applicable to proxy statements and shareholder meetings, and the legislation proposed by the Treasury Department on July 16 regarding compensation committees and "say on pay" for all publicly-traded companies. The Treasury proposals have been submitted to Congress as part of the Investor Protection Act of 2009. Both the SEC and Treasury proposals are expected to be effective for the 2010 proxy season.

SEC Proposed Regulations

Compensation and Corporate Governance Disclosure Requirements

The proposed rules expand the proxy statement disclosure requirements regarding compensation and corporate governance in a number of ways.

- *Effect of Compensation on Risk.* The Compensation Discussion and Analysis ("CD&A") would be expanded to require a discussion of how the company's overall compensation policies and practices for employees generally (not just executive officers) create incentives that can affect the company's risk, if the risk arising from such policies or practices may have a material effect on the company. This disclosure requirement could be triggered if, for example, a particular business unit had compensation structured differently from the rest of the company, was significantly more profitable or involved greater risk than other business units, applied a significant portion of its revenues to compensation expense, or awarded bonuses upon accomplishment of a task while the income and risk to the company from the task extended over a significantly longer period.

  To the extent material, the disclosure would need to address:

  - how the design of the company's compensation policies affects risk taking by employees,
  - the company's risk assessment or incentive considerations in structuring the policies and paying the compensation,
  - the extent to which the policies address long-term risks, such as by imposing clawbacks or holding periods,
  - the extent and nature of changes to the policies to address changes in the company's risk profile, and
  - the extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met.

- *Reporting of Equity Awards.* The Summary Compensation Table and Director Compensation Table would be revised to require disclosure of the aggregate grant date fair value under FAS 123R of equity awards ***granted*** during the fiscal year rather than the amount ***expensed*** during the fiscal year. In line with this change, the incremental fair value of any repriced or modified award would be reported in these tables in the year of modification. In a conforming change, the aggregate grant date fair value would no longer be required to be shown in the Grant of Plan-Based Awards Table.

The proposing release seeks comments on whether the equity grants disclosed should be those made ***during*** the applicable fiscal year, as called for by the current proposal, or should instead be those made ***for services rendered*** in the applicable fiscal year, even if the grants are in fact made after the end of the fiscal year. The latter treatment would be consistent with the current treatment of cash bonus payments.

The release indicates that the SEC is considering whether to require companies to restate amounts for the two prior years reported in the next summary compensation table to reflect the new rule.

- *Director and Nominee Information.* The biographical information about directors and nominees would need to be expanded to describe the specific experience, qualifications and skills that qualify the person to be a director of the reporting company and a member of the board committees on which he or she serves, in light of the company's business and structure. The stated purpose of the disclosure is to enable shareholders to determine if the director or nominee is "a good fit for a particular company."

  In addition, the existing requirement to disclose current directorships held by directors and nominees would be expanded to require disclosure of all director positions with public companies held in the last five years. The disclosure of specified types of legal proceedings involving directors, nominees, and executive officers would be expanded to require reporting of proceedings in the last ten years (rather than the last five years).

  The request for comment on these proposals raises the possibility that the final rules may require one or more of the following:

  - disclosure regarding board diversity,
  - a list and description of functions of *all* board committees,
  - information about whether the board conducts board, committee, and/or director evaluations, and
  - expansion of the types of legal proceedings required to be disclosed.

- *Company Leadership Structure and Risk Management Process.* Disclosure would be required of the company's leadership structure, including whether the positions of chairman and CEO were held by one or two individuals. If both positions were held by a single individual, the company would be required to disclose whether it had a lead independent director and, if so, the specific role played by the lead director. Disclosure would also be required as to why the company believes its leadership structure is appropriate given the company's specific characteristics or circumstances.

  The company would also be required to describe the board's role in the company's risk management process and the effect it has on the company's leadership structure. The proposing release states that this disclosure might include, for example:

  - the relationship between the board and senior management in managing the material risks facing the company,
  - whether the board's risk management function is performed by the board as a whole or by a committee, and
  - whether, and how, the board or committee monitors risk.

  The request for comment on this proposal indicates that the SEC is also considering whether additional disclosure regarding risk management practices should be required in annual and quarterly Exchange Act reports.

- *Compensation Consultants.* If a compensation consultant played any role in determining or recommending the amount or form of executive or director compensation and also provided any additional services to the company, the company would be required to disclose:

  - the nature and extent of all additional services provided by the consultant,
  - the aggregate fees paid to the consultant for the executive/director compensation work and the aggregate fees paid for all other work,
  - whether the decision to engage the consultant for the non-executive work was made, subject to screening, or recommended by management, and
  - whether the board or the compensation committee approved the additional services provided by the consultant.

- *Other Requests for Comment.* The SEC release contains a general request for comments on ways to improve proxy disclosures, particularly in the area of executive compensation. The release specifically seeks comments on the following topics, suggesting that one or more of them may be the subject of future rule proposals:

  - expanding the compensation tables to cover all executive officers,
  - tightening the requirements to disclose performance targets,
  - making the CD&A part of the Compensation Committee Report, and reconsidering whether the report should be "furnished" or "filed,"
  - requiring disclosure of whether a member of the compensation committee has expertise in compensation matters, and whether the committee has resources to hire independent legal counsel,
  - requiring disclosure of whether a company has hold-to-retirement and/or clawback provisions, and if not, why not,
  - requiring disclosure of internal pay ratios, and
  - requiring additional disclosure regarding gross-ups, including the savings to each executive.

Reporting of Voting Results on Form 8-K

The proposed rules include a requirement that the voting results of any item voted on by shareholders be disclosed on Form 8-K within four business days after the end of the meeting at which the vote was taken. If the matter relates to a contested election of directors and the final voting results are not determined within this timeframe, the company would be required to file an 8-K reporting the preliminary voting results within four business days after the preliminary results are determined, and an amended 8-K within four business days after the final results are certified. This proposal would replace the current requirement to report such results on the next Form 10-K or 10-Q filed after the meeting, but would not otherwise change the scope of the reporting requirement.

"Say on Pay" for TARP Recipients

In a separate release, the SEC proposed a new Rule 14a-20 and an amendment to Item 20 of Schedule 14A to implement the requirement under Section 111(e) of the Emergency Economic Stabilization Act of 2008 ("EESA"), as amended, that "TARP recipients" (as defined in the statute) provide a separate shareholder vote to approve the compensation of the company's executives. Companies subject to this requirement would be required to disclose in the proxy statement that they are providing such a vote pursuant to the requirements of EESA, and to explain "the general effect of the vote," such as whether the vote is non-binding.

- Although the proposed rule does not require the proposal to contain any specific language, the shareholder vote must be to approve the compensation of executives as disclosed pursuant to Item 402 of Reg S-K, including the CD&A, the compensation tables, and any related material. Thus a proposal to approve only the compensation policies would not satisfy the rule.

- The requirement applies to all annual meetings as well as any special meeting in lieu of annual meeting at which directors will be elected, but does not apply to other special meetings.

- The requirement applies to all proxies solicited while a TARP obligation is outstanding, even if the shareholder meeting will take place after the TARP obligation has been repaid.

- As proposed, proxy statements containing the proposal required by EESA would need to be filed with the SEC in preliminary form at least ten days before they are sent to shareholders; however the SEC has requested comment as to whether this requirement should be eliminated.

Comments on the TARP recipient "say on pay" proposal are due September 8, and on the remaining SEC proposals on September 15.

Legislation Proposed by Treasury

Shareholder Vote on Executive Compensation

The proposed legislation would amend the Securities Exchange Act of 1934 to require any proxy solicitation by a publicly-traded company for an annual meeting (or special meeting in lieu of annual meeting) to provide for a separate, non-binding shareholder vote to approve the compensation of executives as disclosed pursuant to the SEC compensation disclosure rules, including the compensation committee report, CD&A, compensation tables, and any related materials.

In addition, any proxy statement for a merger or other corporate transaction would be required to disclose, in tabular form, all compensation arrangements between the executive officers and the company (or the acquiring company) that is based on or otherwise relates to the corporate transaction, including the aggregate amount that may be payable to each executive officer. The proxy statement would be required to provide for a separate, non-binding shareholder vote to approve such "golden parachute" compensation.

The SEC would be required to issue regulations implementing these provisions within one year after enactment.

Compensation Committee Requirements

The proposed legislation would amend the Securities Exchange Act of 1934 to add provisions regarding compensation committees that are largely modeled after the provisions governing audit committees that were added by the Sarbanes-Oxley Act. The SEC would be required to act within 270 days of enactment to direct the stock exchanges to implement these requirements as listing standards.

- Compensation committee members would be required to meet the same independence standards as currently apply to the audit committee. Specifically, they could not (other than in their capacity as members of the board or a board committee)

    - accept any consulting, advisory, or other compensatory fee from the issuer, or

    - be an "affiliated person" of the issuer or its subsidiaries.

- Any compensation consultant, legal counsel, or other adviser to the compensation committee must meet independence standards set by the SEC.

- The compensation committee must be given authority to retain compensation consultants, legal counsel, and other advisers, and must be directly responsible for their appointment, compensation, and oversight. The company must provide adequate funding for any such advisers.
- Any proxy statement for an annual meeting occurring more than one year after enactment would be required to disclose whether the compensation committee retained an independent compensation consultant, and if not, why not.
- The SEC would be required to study the use of independent compensation consultants and report to Congress within two years.

For more information about the SEC proxy disclosure proposals, the Treasury legislative proposals, or Hughes Hubbard's executive compensation and corporate governance practices, please contact any of the following attorneys:

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