

December 2009

SEC Approves Expanded Compensation and Corporate Governance and Disclosures

On December 16, 2009, the Securities and Exchange Commission (the "Commission") announced new rules expanding compensation and corporate governance disclosures. The new rules, which are largely consistent with the initial proposal announced on July 1, 2009, were approved by a 4–1 vote. The Commission's stated intent is to: (1) improve the disclosure provided to shareholders regarding compensation and corporate governance matters when voting decisions are made, (2) improve the reporting of annual stock and option awards to company executives and directors, and (3) improve the reporting of elections. The new disclosure rules apply only to U.S. domestic issuers and not foreign private issuers.

While the new rules are disclosure requirements, several of them will require substantially more than just adding disclosures. For example, the corporate governance disclosures will require companies, their boards of directors, and their nominating committees to evaluate each nominee for director and articulate each director's qualifications to serve as a director of the company. Given the unprecedented nature of certain of the new required disclosures and that the rules generally will become effective on February 28, 2010, we

believe that the new rules require companies' immediate attention.

View a copy of the [final rule](#).

Corporate Governance Disclosures

The Commission approved several rule changes intending to enhance disclosure about compensation and corporate governance matters. The specific revisions are described below.

Compensation and Risk Disclosures

An amendment to Item 402 of Regulation S-K will require a company to discuss and analyze its broader compensation policies and overall compensation practices for all employees, not just executive officers, *if* risks arising from those compensation policies and practices are reasonably likely to have a material adverse effect on the company, a standard that parallels MD&A disclosures. The final release notes that companies may consider various compensation policies and practices that mitigate or offset one another in determining whether they are reasonably likely to have a material adverse effect on the company as a whole.

The Commission, which has identified these rules as being principles-based, stated that situations that

could potentially trigger discussion include, among others, 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 in which 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 rule does not require a company to make an affirmative statement that it has determined that the risks are not likely to meet the threshold.

Smaller reporting companies¹ are not required to provide the new disclosure. This rule is part of a broader focus on companies' risk management policies following the recent financial crisis.

Stock and Option Awards

Another amendment to Item 402 of Regulation S-K requires the disclosure of stock awards and option awards in the Summary Compensation Table, Grants of Plan-Based Awards Table and Director Compensation Table, using the aggregate grant date fair value of awards (computed in accordance with FASB Accounting Standards Codification™ Topic 718, Compensation – Stock Compensation [formerly SFAS 123R]), rather than using the dollar amount recognized as an expense for purposes of financial statement reporting. In addition, the amendment includes a special instruction relating to performance-based awards to address concerns that the new rule might discourage the use of these awards. The Commission is implementing the Summary Compensation Table amendments by requiring companies providing Item 402 disclosure for a fiscal year ending on or after December 20, 2009, to present recomputed disclosure for each preceding fiscal year, among other requirements.

Director and Nominee Disclosures

The amendments to Item 401 of Regulation S-K require enhanced disclosure for each director

¹ "Smaller reporting company" means an issuer that is not an investment company, an asset-backed issuer or a majority-owned subsidiary of a parent that is not a smaller reporting company and has a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter.

and any nominee for director, including those nominees put forward by other proponents. The required disclosures include:

- the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company, including those who are not up for reelection and those who are nominated by a shareholder;
- other public company directorships held by each director and nominee at any time during the past five years, as opposed to disclosure only of currently held directorships, as required under the current rules; and
- each director's and nominee's involvement in legal proceedings, including any judicial or administrative proceedings resulting from involvement in mail or wire fraud or violations of securities, commodities, banking or insurance laws and any disciplinary sanction imposed by a stock, commodities or derivatives exchange, during the past 10 years, as opposed to the past five years, as required under the current rules.

In addition, the Commission adopted amendments to Item 407(c) of Regulation S-K to require disclosure of whether and how a nominating committee considers diversity in identifying nominees for director, as well as how the committee implements its diversity policy, if any, and how it assesses the effectiveness of its policy. The amendments do not provide a definition of diversity, and the Commission notes that "some

companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes ... while others may focus on diversity concepts such as race, gender and national origin."

Leadership Structure and Risk Oversight

An amendment to Item 407 of Regulation S-K and a corresponding amendment to Item 7 of Schedule 14A require disclosure of the company's leadership structure and a description of why the company believes it is the most appropriate structure for it. Companies are also required to disclose:

- whether and why they have chosen to combine or separate the chief executive officer and board chair positions;
- whether and why the company has a lead independent director, if any, as well as the specific role this director plays in the leadership of the company; and
- the board's role in the company's risk oversight process and the effects this role has on the company's board leadership structure.

In connection with the Commission's focus on risk oversight, the final release notes, among other things, that companies "may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board ... or to a board committee or how the board or committee otherwise receives information from such individuals."

Compensation Consultant Disclosures

Another amendment to Item 407 of Regulation S-K requires disclosure about 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, *if* they also provide other services to the company. If the board has engaged its own consultant, the company must disclose, as applicable, a description of:

- the fees paid for any non-executive compensation consulting services provided to the company by the compensation consultant or any of its affiliates, provided that the fees for these non-executive compensation consulting services exceed \$120,000 during the company's fiscal year, but the company need not disclose the nature or extent of the additional services;
- whether the consultant was engaged for these other services by or on the recommendation of management; and
- whether the board or compensation committee approved the non-executive compensation consulting services.

If the board has not engaged its own consultant, fee disclosures are required only if the fees for these non-executive compensation consulting services exceed \$120,000 during the company's fiscal year. Disclosure for consultants that work with management is not required if the board has its own consultant. Disclosure is also not required in those

situations in which 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, such as 401(k) plans or health insurance plans, or providing merely general information.

Expedited Voting Results

The Commission also added a new Item 5.07 to Form 8-K to require a company to disclose the results of a shareholder vote within four business days after the end of the meeting at which the vote was held, rather than on the company's next Form 10-Q or Form 10-K. If the voting results are not definitively determined at the end of the meeting, companies must disclose the preliminary voting results within four business days after the meeting at which the vote was held, and then file an amended report within four business days after the final voting results are determined. The disclosure of preliminary results in close votes or contested matters may increase media and shareholder scrutiny of the voting process.

Effective Date

The amendments will become effective on February 28, 2010, except that an amendment to the reporting of equity awards in the Summary Compensation Table applies to all companies with fiscal years ending on or after December 20, 2009. On December 22, 2009, the [Commission's staff issued guidance](#) as to how the effective date should be interpreted and related matters such as the treatment of preliminary

and definitive proxy statements that straddle the effective date:

- if a company's fiscal year ends on or after December 20, 2009, its Form 10-K and proxy statement must be in compliance with the new proxy disclosure requirements if filed on or after February 28, 2010;
- if a company is required to file a preliminary proxy statement and expects to file its definitive proxy statement on or after February 28, 2010, then the preliminary proxy statement must be in compliance with the new proxy disclosure requirements, even if filed before February 28, 2010;
- if a company files its 2009 Form 10-K before February 28, 2010, and its proxy statement on or after February 28, 2010, the proxy statement must be in compliance with the new proxy disclosure requirements; and
- if a company's fiscal year ends before December 20, 2009, its 2009 Form 10-K and related proxy statement are not required to be in compliance with the new proxy disclosure requirements, even if filed on or after February 28, 2010.

The Commission also stated that it will permit companies not otherwise subject to the disclosure requirements to comply with the new rules on a voluntary basis, provided that if companies adopt the Summary Compensation Table and Director Compensation Table amendments, they must observe all of the Regulation S-K amendments. In addition, the

Commission advised that the Form 8-K amendments requiring disclosure of shareholder meeting results apply to any meeting held on or after February 28, 2010, regardless of when the proxy statement for the meeting was mailed.

Conclusion

The new rules reflect the Commission's ongoing focus on corporate governance. Companies will need to give specific attention to these new rules in preparing their proxy materials for 2010 annual meetings, particularly given the short time frame set by the February 28 effective date. In addition to drafting new disclosures, potential action items may include:

- discussing with a nominating committee how to explain its rationale for nominating directors

and whether to establish a formal diversity policy;

- holding board and nominating committee meetings to assess board leadership, risk oversight and board composition;
- updating or supplementing D&O questionnaires regarding legal proceedings and other directorships, and potentially requesting additional biographical information relevant to each director's qualifications;
- assessing the impact of the new grant date fair value reporting and recomputing the value of stock-based awards for prior years;
- evaluating the company's current leadership structure and why such

a structure is appropriate for the company;

- developing leadership structure evaluation policies;
- determining whether the new disclosures will apply to the company's compensation consultants and, if so, how to obtain the required information; and
- for companies filing proxy statements prior to February 28, determining whether to comply with the rules in advance.

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