LEDGEWOOD
A PROFESSIONAL CORPORATION

Memo

To: Our Clients and Friends

Date: December 18, 2009

Re: Final Rule: Executive Compensation and Corporate Governance Disclosure

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On December 16, 2009, the SEC adopted rules changing executive compensation and corporate governance disclosure.[1] The new rules take effect on February 28, 2010, which means that they will apply to Form 10-Ks and proxy statements filed on or after that date. Some of the disclosure changes may require companies to analyze compensation and governance practices anew before proxy season starts.

This memorandum summarizes the final rules, and recommends steps that should be considered in order to implement the rule changes.

<u>Compensation Risk Analysis</u>

New S-K Item 402(s) requires disclosure about how a company's compensation policies and practices create incentives that can affect the company's risk if the risks arising from the compensation polices and practices are reasonably likely to have a material adverse effect on the company.[2] Significantly, this disclosure is required with respect to the company's overall compensation practices, including those for employees who are not named executive officers.

Companies will need to assess whether and how their incentive compensation practices might encourage employees to take on risks in order to earn the incentive compensation. They will also need to determine whether the risks arising from their compensation practices are likely to have a material adverse effect on the company. A company may determine that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect, and therefore that no additional disclosure is required. For example, the company may have compensation arrangements that mitigate inappropriate risk-taking.

The rules provide a non-exhaustive list of situations that potentially could trigger the disclosure requirement:

- a business unit carries a significant portion of the company's risk profile;

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[1] SEC Release No. 33-9089 (December 16, 2009) (the "Issuing Release").

[2] The final rule is different from the proposed rule in the following respects:

- The required disclosure is not part of Compensation Discussion and Analysis ("CD&A").
- Disclosure is required only if compensation policies and practices are "reasonably likely" (as opposed to "may") to have a "material adverse effect" (as opposed to simply "material effect).
- The SEC determined not to require an affirmative statement that the company has determined that the risks arising from its compensation policies are not reasonably expected to have a material adverse effect.

- compensation at a business unit is structured significantly differently than compensation at other business units;
- a business unit is significantly more profitable than other business units;
- compensation expense is a significant percentage of a business unit's revenues; or
- the company has in place compensation policies or practices 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 time.

The rules provide examples of the issues that a company may need to address if it determines that disclosure is required:

- the general design philosophy of, and manner of implementing, the company's compensation policies for employees whose risk-taking on behalf of the company would be most incentivized by those policies;
- the company's risk assessment or incentive considerations, if any, in structuring its compensation policies or in awarding and paying compensation;
- how the company's compensation policies relate to the realization of risks resulting from the actions of employees in both the short-term and long-term, such as through policies requiring claw backs or imposing holding periods;
- the company's policies regarding adjustments to its compensation policies to address changes in its risk profile;
- material adjustments the company has made to its compensation policies or practices as a result of changes in its risk profile; and
- the extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

In the Issuing Release, the SEC noted that boilerplate statements that the incentives are designed to have a positive effect, or that compensation levels may not be sufficient to attract and retain employees with appropriate skills in order to enable the company to maintain or expand operations, is discouraged.

<u>Additional Director, Director Nominee and Executive Officer Disclosure</u>

The new rules amend S-K Item 401 to require the following additional disclosure:

- Item 401 currently requires only brief biographical information about directors and nominees for the past five years, and Item 407 requires general disclosure about director qualification requirements. The new rules require additional disclosure detailing for each director and nominee the particular experience, qualifications, attributes or skills that led the board of directors to conclude that the person should, as of the time of the disclosure, serve as a director of the company. If material, the disclosure should cover more than the past five years, including information about the person's areas of expertise or other relevant qualifications. Unlike the proposed rules, the final rules to not require disclosure about a director's risk assessment skills or other specific information. However, the SEC stated in the Issuing Release that disclosure should be made if a person was chosen to be a director or nominee because of a particular qualification related to service on a specific board committee, or if the person's particular skills, such as risk assessment or financial reporting expertise, were part of the considerations that led the board to believe that the person should serve as a director.

- Disclosure of any directorships held by the director or nominee at publicly-traded companies or registered investment companies during the past five years, rather than just directorships currently held.

- Disclosure of legal proceedings involving the director, nominee or executive officer over the past 10 years, rather than just five years. In addition, the categories of legal proceedings as to which disclosure is required has been expanded to include:

    - any judicial or administrative proceedings resulting from involvement in mail or wire fraud, or fraud in connection with any business entity;

    - any judicial or administrative proceedings based on violations of securities, commodities, banking or insurance laws, or any settlement of such actions; and

    - any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

In addition, new Item S-K 407(c)(2)(vi) requires disclosure of whether, and if so how, a nominating committee considers diversity in identifying director nominees. Companies are permitted to define diversity in whatever way they consider appropriate, whether they conceptualize it expansively to include differences of viewpoint, professional experience, education, skill or other qualities or focus on concepts such as race, gender or national origin.

<u>Board Leadership Structure and Role in Risk Oversight</u>

New S-K Item 407(h) requires disclosure of whether and why a company has chosen to combine or separate the chairman and chief executive officer positions. If the positions are combined, the company is required to disclose whether it has a lead independent director and the role the lead independent director plays. In addition, the company must describe why it has determined that its leadership structure is appropriate given the company's specific characteristics or circumstances.

In addition, Item 407(h) requires disclosure of the extent of the board's role in risk oversight of the company, such as the following:

- how the board administers its oversight function, such as through the whole board or through a separate risk or audit committee, and whether the persons who oversee risk management report directly to the board as a whole; and

- the effect the board’s role in risk oversight has on its leadership structure.

Valuation of Stock and Option Awards in Summary Compensation Table

The new rules revert to the SEC’s original requirement that the value reported for stock and option awards in the summary compensation table and director compensation table be their aggregate grant date fair value, as opposed to the amount recognized for financial reporting purposes in the fiscal year. This change will eliminate the current difference between the value reported in the summary compensation table and the grants of plan-based awards table. Under the new rules:

- Disclosure is required of awards granted during the fiscal year, not of awards granted for the fiscal year but granted after fiscal year-end. Thus, if a company makes equity awards after fiscal year-end based on performance during the last completed fiscal year, those awards would not need to be reported until the next fiscal year. However, the SEC stated in the Issuing Release that companies having this practice should analyze in CD&A their decisions to grant post-fiscal year-end equity awards “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 “where it facilitates understanding the CD&A.”

- New Instruction 3 to 402(c)(2)(v) and (vi) requires that the grant date value of performance-based awards be based on the probable outcome of the performance-based conditions.
  This amount will be the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under FASB ASC Topic 718, excluding the effect of estimated forfeitures. In addition, companies must disclose in a footnote the grant date value of the award assuming that the highest level of performance conditions will be achieved.

- Companies providing disclosure for a fiscal year ending after December 20, 2009 are required to present recomputed equity award amounts for each fiscal year required to be included in the table.

Potential Conflicts of Compensation Consultants

As with the potential conflicts of interest that the SEC has previously identified with respect to auditing accountants, the SEC is concerned that where compensation consultants provide services (such as benefits administration, human resources consulting and actuarial services) in addition to advice and recommendations on executive and director compensation, management’s influence on the consultants as a result of the fees generated by these additional services may create a conflict of interest that calls into question the objectivity of the consultant’s compensation advice to the board or compensation committee. If compensation consultants play any role in determining or recommending the amount or form of executive or director compensation, revised S-K Item 407(e)(3) (iii) requires disclosure with respect to fees paid to the consultants and their affiliates for other services in certain circumstances, depending in part on whether the compensation consultants are retained by the board (or compensation committee) or management:

- If the board or compensation committee has engaged its own consultant to provide advice or recommendations on the amount or form of executive and director compensation and the board's consultant or its affiliates provide other non-executive compensation consulting services to the company, the aggregate fees for compensation consulting services and the aggregate fees for other consulting services must be disclosed if the fees for the other consulting services exceeded $120,000 during the company’s last completed fiscal year. Disclosure is also required of whether the decision to engage the compensation consultant or its affiliates for other consulting services was made or recommended by management, and whether the board or compensation committee has approved the other consulting services.

- If the board or compensation committee has not engaged its own consultant, but management has engaged a consultant to provide executive compensation consulting services and other consulting services, fee disclosure is required if the fees for the other consulting services exceeded $120,000 during the company's last completed fiscal year.

- Fee and related disclosure for consultants that work with management (whether for only executive compensation consulting services, or for both executive compensation consulting and other non-executive compensation consulting services) is not required if the board or compensation committee has its own consultant. This exception applies even if management's consultant participates in board meetings.

- Services involving only broad-based non-discriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant, are not treated as executive compensation consulting services for purposes of the disclosure rules. However, this exception is not available if the consultant provides advice or recommendations in connection with the survey information.

- Disclosure is not required with respect to the nature and extent of the additional services provided by the compensation consultant and its affiliates. However, companies may include a description of such services where the information would facilitate understanding of the existence or nature of any potential conflict of interest.

Reporting Voting Results on Form 8-K

The new rules require results of stockholder votes to be reported on a Form 8-K within four business days after the meeting, rather than in the Form 10-Q or 10-K covering the quarter in which the meeting occurred.

Recommendations

Companies should consider taking the following steps in order to comply with the new disclosure requirements:

- review whether the company's overall compensation policies and practices encourage risky behavior by employees, and whether those risks could be materially adverse to the company; consider implementing modifications or measures to address the effects of such incentives;

- update D&O questionnaires and consider whether any additional procedures are necessary in order to provide the required additional disclosure regarding the qualifications of directors and nominees, past directorships held by directors and nominees, and legal proceedings involving directors, nominees and executive officers during the past 10 years;

- assess whether the board leadership structure continues to serve the company and its objectives; if the chief executive officer is also the chairman of the board, consider appointing a lead independent director and formalizing such role in writing in the company's corporate governance guidelines;

- review the board's risk oversight role and consider whether any changes should be made; and

- analyze the likely effect to the summary compensation table of revised valuations of stock and option awards and awards anticipated for the 2009 fiscal year, whether or not granted during the fiscal year.

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