

Securities

January 7, 2010

SEC Adopts Enhanced Executive Compensation and Governance Disclosure Rules

On December 16, 2009, the Securities and Exchange Commission adopted final rules, effective February 28, 2010, intended to improve corporate governance disclosures and to clarify the SEC's proxy rules. On December 22, 2009, the SEC published Compliance and Disclosure Interpretations (C&DIs) providing guidance as to transition dates for the new rules.

This advisory provides a summary of those changes, updated to reflect the transition interpretations, and our guidance on actions that companies should consider now in preparation for the new requirements.

The final rules require companies to disclose certain compensation policies and practices that could incentivize risk-taking in certain instances, as well as the board's role in risk management. They also require additional disclosure relating to the board's practices to encourage diversity, and its consideration of qualifications of directors, as well as expanded disclosure of legal proceedings involving directors. Finally, the final rules change the calculation for equity compensation in the Summary Compensation Table, require disclosure of fees paid to compensation consultants in certain circumstances, and require shareholder voting results to be disclosed on Form 8-K within four business days following the end of a shareholder meeting. A more detailed explanation of the final rules is set forth below.

Click [here](#) for the Final Rule Release No. 33-9089 and [here](#) for the transition C&DIs.

Compensation and Risk Management

New Item 402(s) of Regulation S-K requires proxy statement disclosure of a company's compensation policies and practices applicable to all employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives, *but only if* such risks are reasonably likely to have a material adverse effect on the company. The SEC has heightened the threshold for disclosure from "may" in the proposed rules to "reasonably likely" in the final rules. Given the relatively high standard for disclosure, few companies are likely to conclude that disclosure is necessary, but all companies should engage in a review and analysis. However, if a company does make such a determination, disclosure is required in a section separate from the Compensation Discussion and Analysis and could be together with other disclosures focusing on the compensation

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committee governance processes. The requirements for the disclosure are set forth in the release. Smaller reporting companies are not required to comply with this new disclosure requirement.

The SEC provided the following examples of situations to be considered where a company has compensation policies and procedures at business units that:

- represent a significant portion of the company's risk profile;
- have compensation structured significantly differently than other units within the company;
- are significantly more profitable than others within the company;
- have compensation expense as a significant percentage of the unit's revenues; or
- have a compensation structure that varies 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.

Calculation of Amount of Equity Compensation

Items 402(c) and 402(k) of Regulation S-K as amended require reporting of the aggregate grant date fair value of awards granted in the fiscal year in the Summary Compensation Table (SCT) and Director Compensation Table, respectively, rather than current disclosure of the dollar amount of stock-based compensation recognized in that year for financial statement reporting purposes. For awards that are subject to performance conditions, the tabular disclosure is based upon the probable outcome of the performance conditions as of the grant date (i.e., the target amounts). Additionally, a footnote indicating the grant date fair value, assuming that the highest level of performance conditions are achieved, is also required as part of the disclosure. For the named executive officers determined based on 2009 total compensation who are included in the Summary Compensation Table, the grant date fair value must also be presented in each prior year of the table, coupled with an updated total compensation value. The Summary Compensation Table and Director Compensation Table provisions applicable to smaller reporting companies, Items 402(n) and 402(r) of Regulation S-K, respectively, have been similarly amended to require reporting of the aggregate grant date fair value of awards.

Board of Directors—Enhanced Disclosure

Amended Item 401(e) of Regulation S-K requires disclosure in a proxy statement (or Form 10-K of companies which are not subject to the proxy statement rules) of information related to the board's composition. This includes the specific experience, qualifications, attributes and skills that led to the board's conclusion that each nominee, including incumbent directors, should serve or continue to serve on the board. While the SEC did not specify any particular skills that must be addressed in the disclosure, the SEC did state that, if risk assessment skills or financial reporting expertise were considered when assessing a candidate for the board, or if a specific skill or attribute was considered in connection with an anticipated appointment to a particular board committee, those skills should be disclosed. The placement of new disclosures should be determined on a case-by-case basis, taking into account the nature of the new disclosures, and how the company has structured its disclosures. However, the SEC decided to retain existing disclosure about the minimum qualifications that the nominating committee considers in the nomination process, and the new disclosure could be included together with the current disclosures. Depending on the nature of the disclosures, the new disclosure may be more suitably included together with the business background disclosure of directors and nominees.

- Amended Item 407(c) of Regulation S-K requires disclosures of whether, and if so, how, the nominating committee (or the board) considers diversity when identifying nominees for director. If the company has a policy to consider diversity in nominating directors, it must disclose how it is implemented and the nominating committee's or the board's assessment of its effectiveness. The rules do not define diversity and the SEC clarifies that some companies may consider diversity more expansively than race, gender and national origin and may conceptualize diversity to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity.

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- Items 401(e) and 401(f) of Regulation S-K have been amended to require disclosure of other public company and registered investment company directorships during the prior five years and specified legal proceedings during the prior ten years, compared to five years previously required. The specified legal proceedings have 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 federal or state securities, commodities, banking or insurance laws and regulations, or any settlement to such actions; and
 - any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Consistent with the current disclosure requirement regarding legal proceedings, the additional legal proceedings included in the new requirements will not need to be disclosed if the company determines that they are not material to an evaluation of the ability or integrity of the director or director nominee. Also, there is no disclosure required regarding civil lawsuits settled among private litigants. In most cases, we expect companies will include any new disclosures together with existing disclosure of legal proceedings, although in some cases it may be helpful or prudent to also address such matters with the discussion of a particular director's qualifications.

Board of Directors—Risk Oversight and Structure

New Item 407(h) of Regulation S-K requires disclosure of the leadership structure of the board, including whether and why it has chosen to combine or separate the roles of principal executive officer and board chairman. Additionally, if a company combines the role of principal executive officer and board chairman, the company must disclose whether it has a lead independent director and what roles the lead director plays.

New Item 407(h) of Regulation S-K requires proxy statement disclosure describing the board's role in risk oversight, including how the board administers its oversight function and how such administration operates in the context of the board leadership structure, including whether and how the responsibilities are allocated among different board committees. This disclosure includes:

- the relationship between the board and senior management in managing the material risks;
- whether risk oversight is performed by the board as a whole or through a committee;
- whether the persons who oversee risk management report to the board as a whole or to a committee; and
- whether and how the board monitors risk.

We expect that companies will include the new disclosure together with existing disclosures about the governance practices of its board, and particularly together with any existing disclosure about the role of a lead independent director or similar function.

Compensation Consultants

Amended Item 407(e)(3) of Regulation S-K requires disclosure in certain circumstances of fees paid to compensation consultants who advise both the board of directors and management.

A company must separately disclose a compensation consultant's fees for executive compensation advice and other services if:

- the board (including the compensation committee or other persons performing equivalent functions) 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 and the fee paid to such consultant exceeds \$120,000 during the company's last fiscal year. Disclosure is also required of whether the decision to engage the compensation consultant or its affiliates for non-executive

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- compensation consulting services was made or recommended by management, and whether the board has approved these non-executive compensation consulting services provided by the compensation consultant or its affiliates; and
 - there is a consultant (including its affiliates) providing executive compensation consulting services and non-executive compensation consulting services to the company, and the fees for the non-executive compensation consulting services exceed \$120,000 during the company's fiscal year, even if the board did not engage the consultant.

However, disclosure of a compensation consultant's fees is not required if:

- a consultant advises management (whether for only executive compensation consulting services, or for both executive compensation consulting and other non executive compensation consulting services) and the board has its own separate consultant; or
- the services involve 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.

We expect that most companies will include the new disclosures together with existing disclosure on compensation committee activities.

Form 8-K Reporting of Shareholder Vote Results

New Item 5.07 of Form 8-K requires that shareholder meeting voting results be reported on Form 8-K rather than currently in Form 10-Q for the quarter in which the meeting occurred (or on Form 10-K in the case of a fourth quarter meeting). The company is required to file final voting results on Form 8-K within four business days following the end of the meeting. If final results are not available within four business days, then preliminary results are required to be reported, the final election results must be filed on an amended Form 8-K within four business days of certification.

Transition Dates

The new rules are generally effective February 28, 2010. As provided in the SEC's C&DIs, for a company with a fiscal year which ends on or after December 20, 2009, the company's Form 10-K and the definitive proxy statement must comply with the new rules unless both are filed before February 28, 2010. Prior to February 28, 2010, a company may voluntarily comply with all or some of the new rules, except that if it elects to present grant date fair market value in the Summary Compensation Table and Director Compensation Table, it must comply with all other disclosure requirements under the new rules. All registration statements that are declared effective after February 28, 2010, must comply with the new rules unless the registration statement was first filed prior to December 20, 2009. Form 8-K reporting of voting results is required for annual shareholder meetings on or after February 28, 2010.

What to Do Now

- Determine application of transition dates to your company's annual meeting calendar—If a calendar year company prefers to defer compliance with the new rules until its disclosures for its 2011 annual meeting, consider whether the Form 10-K and definitive proxy statement can be filed prior to February 28, 2010.
- Revise D&O Questionnaire—The questionnaire to be distributed in early January 2010 for calendar year companies must be revised. Companies must request information relative to the revised disclosures with respect to past public directorships and expanded legal proceedings.
- Determine 2009 named executive officers (NEOs)—For purposes of identifying the most highly compensated executives for inclusion in the Summary Compensation Table and related tabular and narrative compensation disclosure, total compensation must be calculated based on the grant date fair market value of equity awards during 2009. NEOs newly identified based on the new values may require the drafting of additional disclosure, as well as the filing of their compensation agreements as exhibits to Form 10-K.

- Communicate with the board—The requirements of the new rule with respect to enhanced disclosures of corporate governance considerations must be communicated to the board in particular with respect to ongoing nominating and compensation committee policies and activities. The board should consider whether it is comfortable with existing policies that are implicated by the new requirements (e.g., on board diversity), as well as with how those policies are implemented and their effectiveness assessed. It should also consider policies and procedures with respect to the director nominations (including any new information that will be disclosed about a particular director or nominee under the new rules), board structure and risk oversight. The board should also consider the nature of services performed by its compensation consultants, how such relationships are established and managed, and corresponding approval procedures. The board may wish to gather additional information about directors' and board nominees' skills and qualifications through discussions or questionnaires in connection with its deliberations on the slate of nominees. Draft proxy statement disclosure may be prepared to inform the board as to the practical aspects of these requirements.
- Review disclosure controls and procedures—Management and the board should consider establishing or assessing disclosure controls and procedures designed to collect information necessary to generate the new disclosures, including with respect to the fees paid to compensation consultants and related approval procedures.
- Analyze risk management—Management should analyze material risks in its compensation programs in order to report to the compensation committee potential risks that the committee should be considering in connection with its review of the company's overall compensation program. This activity should commence in early January 2010 so that the compensation committee may have access to this information in connection with 2009 compensation decisions made in late January or February 2010 meetings.
- Revise the SEC reporting calendar—The requirement of filing an Item 5.07 Form 8-K within four business days following the end of the annual meeting to disclose voting results should be included.



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