

# New SEC Rules on Risk, Executive Compensation, and Other Corporate Governance Matters

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## Outline of Discussion

- Background of New Rules
- Implementation Timeline
- Scope and Topics Covered
- Transition Provisions
- Requirements of New Rules

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## Background of New Rules

- SEC has been trying to control executive compensation for many years
- SEC governs through enforcement (blunt instrument) and disclosure requirements
- First substantial executive compensation disclosure requirements adopted in 1992, including Summary Compensation Table and other tables
- Financial debacles of early 2000s resulted in Sarbanes-Oxley Act of 2002, but did not slow the pace of executive compensation increases
- Tables expanded and substantial details added in 2006, along with CD&A section
- Shareholder watchdog groups like RiskMetrics, and activist shareholders presenting shareholder proposals, have cranked up the heat on the boardroom
- Foreign countries have already directly legislated executive compensation

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## SEC Rule Implementation Process

- SEC proposed latest rules in July 2009
- Approved, with some modifications, on December 16, 2009
- SEC Release Nos. 33-9089 and 34-61175
- Effective February 28, 2010
- Special Transition Rules

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## Scope of New Rules

- New rules mandate enhanced disclosures of:
  - Risk management in compensation programs
  - Valuation of equity awards for SEC disclosure purposes
    - no change to GAAP accounting requirements for financial statements
  - Director and nominee qualifications
  - Enhanced biographical data for directors, director nominees and executive officers
  - Board diversity
  - Board leadership structure and risk oversight role
  - Fees paid to compensation consultants
- New 8-K requirement for reporting the results of shareholder meetings

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## Transition Rules

### December 20, 2009 Fiscal Year End cutoff

- All Securities Act and Exchange Act filings on or after February 28, 2010 must comply, if company's fiscal year ends on or after December 20, 2009
- If fiscal year ends before December 20, 2009:
  - the 2009 Form 10-K and related proxy statement not required to comply
  - Compliance not required until after the due date of 2010 Form 10-K
- For an IPO or first Exchange Act registration, if the registration statement is not declared effective by February 28, 2010, must comply with the new rules unless initial registration statement is filed before December 20, 2009
- Form 8-K – four business day deadline to report result of shareholders meetings which end on or after February 28, 2010
- Early voluntary compliance is permitted, subject to certain conditions

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## Compensation and Risk Management

### Compensation Policies and Practices Relating to Risk Management

- Disclose in proxy statement whether company's policies and practices create risks that are reasonably likely to have a material adverse effect on the company
- Applies to compensation policies and practices for all employees, not just executives
- Intended to be a narrative apart from the CD&A or any other executive compensation disclosure
- New rule does not clarify what constitutes a "policy" or "practice." of:
  - Is a formal written policy detailing the steps taken in connection with risk management for compensation matters required?
  - Is it sufficient that issues of risk management are discussed and acted upon routinely at the board or management level?

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## Compensation and Risk Management

- Types of policies or practices giving rise to the type of risks that would merit disclosure vary depending on the particular company and its compensation programs
- SEC specified a non-exclusive list of examples of such situations – 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

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## Compensation and Risk Management



(list continued)

- at a business unit that is significantly more profitable than others within the company
- at a business unit where the compensation expense is a significant percentage of the unit's revenues
- 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

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## Compensation and Risk Management



### “Reasonably likely” standard

- Discuss the risk and the compensation program making the risk reasonably likely
- “Reasonably likely” standard permits companies to consider compensating or offsetting steps or controls designed to limit or mitigate risks of certain compensation arrangements
  - Claw-back arrangements
  - hold-to retirement
  - hold-through retirement
  - limits or caps on incentive compensation

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## Compensation and Risk Management

### Contrast with TARP Rules

- Different approach than required by Congress for financial institutions participating in TARP program
- Each TARP company compensation committee must:
  - certify that it has met with senior company risk officials to ensure that compensation arrangements do not encourage senior executive officers to take unnecessary risks that threaten the value of the company
  - provide an explanation of how the company's senior executive compensation arrangements do not encourage excessive and unnecessary risk taking
- In contrast, new SEC rule on compensation risk disclosure does not specifically mandate any risk assessment or any related certification
- Also contrasts with the existing SEC requirement to disclose effectiveness of disclosure and internal financial controls, and related senior executive officer certifications

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## Smaller Reporting Companies

### New risk management policy disclosure rules do not apply to “smaller reporting companies”

- “Smaller reporting company” is generally defined as public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter
- A company that is not a smaller reporting company will become a smaller reporting company if had a public float of less than \$50 million as of the last business day of its most recently completed second fiscal quarter

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## Revisions to Summary Compensation Table

- **Aggregate Grant Date Fair Value for Equity Awards**
  - Summary Compensation Table
  - Director Compensation Table
- Replaces prior rule requiring that, with respect to stock and option awards, equity awards were disclosed based on dollar amount recognized with respect to these equity awards for financial statement reporting purposes for the applicable fiscal year
- New disclosure considered to best represent compensation committee decisions with respect to stock and option awards to executive officers

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## Revisions to Summary Compensation Table

- Double reverse by SEC – second time SEC has reversed its position on this same issue
- New rule is the same as the original rule in place at the time the executive and director compensation rules were overhauled in August 2006
- “December Surprise” – in December 2006, after the new compensation disclosure rules had become effective, the SEC reversed itself, adopting the rule that has been in effect since then

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## Revisions to Summary Compensation Table

### More frequent changes in the “named executive officers” (NEOs)

- NEOs (other than the principal executive and principal financial officers) are the three who received the most compensation, determined based on total compensation, i.e. sum of all compensation reported for the latest fiscal year
- Large one-time grants, including for new hires, can push an executive into the top three, and can result in lack of consistency in NEOs from year to year

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## Revisions to Summary Compensation Table

### How are the NEOs determined for the last three fiscal years?

- Compensation for three most recent years will be provided for the NEOs determined for the most recently completed year
  - companies will not make new determinations of who would have been the named executive officers for prior years if the new rules had been in effect in those years
- Summary Compensation Table amounts for prior years are required to be recomputed based on the new rules, with reference to the NEOs determined for the latest fiscal year
  - companies will need to recompute the amounts to be set forth in the stock and option awards columns of the Summary Compensation Table and the Director Compensation Table for 2007, 2008 and 2009
  - recomputation also impacts the total compensation amount for each NEO and director

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## Revisions to Summary Compensation Table

### Special Treatment for performance-based awards

- Report aggregate grant date fair value of performance awards based on the probable outcome of the performance conditions, not assuming that the maximum performance level will be achieved
- Footnote disclosure required of the maximum value of the award assuming the highest level of the performance conditions is achieved

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## Revisions to Summary Compensation Table

### Potential Imbalance in reporting of Cash vs. Equity Awards

- Equity awards are reported with respect to the fiscal year in which they are granted, not the fiscal year of the services with respect to which they were granted
  - For example, if grant is made in February 2010, with respect to 2009 services, these awards will first be reported in the Summary Compensation Table or Director Compensation Table in the proxy statement filed in 2011
- Can result in imbalance in the reporting of cash and equity awards for a particular executive officer or director, as bonuses are reported based on the fiscal year in which they are earned
- Post-fiscal year equity grants to NEOs will still need to be analyzed in the CD&A section of the proxy statement

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## Enhanced Director Information

### Director and Nominee Qualifications

- Briefly discuss the specific
  - experience
  - qualifications
  - attributes
  - skills

that led to the conclusion that the person should serve as a director for the company at the time that the disclosure is made, in light of the company's business and structure.

- If material, cover more than the past five years, including director's or nominee's particular areas of expertise or other relevant qualifications.

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## Enhanced Director Information

### Director and Nominee Qualifications

- Also applies to incumbents not up for reelection
- Also applies to with respect to proxy statements of shareholders conducting their own proxy solicitations for the election of directors
- No requirement to disclose board committee qualification, unless director is selected because of a particular qualification or experience perceived to be relevant to service on a specific board committee
- In addition to the existing requirement to describe the specific minimum qualifications and specific qualities or skills used by the nominating committee in determining whether to nominate a person to stand for election as a director

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## Enhanced Director Information

### Present and Past Directorships

- Requires disclosure of each director's and nominee's directorships at public companies and registered investment companies within the past five years, even if the director or nominee no longer serves as a director of any of those companies.

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## Enhanced Director and Officer Information

### Legal Proceedings Involving Directors or Nominees

- Extends the time with respect to which legal proceedings involving directors, nominees for director, and executive officers is required, from 5 to 10 years
- Expands types of legal proceedings about which disclosure is required with respect to directors, nominees for director, and executive officers

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## Board Diversity

- Disclose whether, and if so how, the nominating committee (or the board) considers diversity in identifying nominees for director
- If nominating committee (or board) has a policy, describe how this policy is implemented, as well as assessment of effectiveness of the policy
- No particular definition of diversity. Examples include:
  - differences of viewpoint
  - professional experience
  - education
  - skill
  - other individual qualities and attributes that contribute to board heterogeneity
  - or more traditional factors such as race, gender and national origin.
- No specific requirement for company to set forth its definition of diversity
- No specific requirement for company to set forth the elements of its diversity policy.

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## Board Leadership Structure

### Disclose Leadership Structure of Board of Directors

- Disclose whether the same person serves as both principal executive officer and chairman of the board, or whether two individuals serve in those positions.
- If same person serves as both principal executive officer and chairman of the board, disclose whether the board includes a lead independent director and, if so, what specific role the lead independent director plays in the leadership of the board

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## Board Leadership Structure

- Why has the company determined that its leadership structure is appropriate given the specific characteristics or circumstances of the company, and what are the reasons why the company believes that this board leadership structure is the most appropriate structure for the company at the time of the filing?
- RiskMetrics will recommend in favor of shareholder proposals recommending separation of the chairman and CEO roles, except in circumstances where the company has a specified counterbalancing governance structure, including an active lead independent director.

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## Board's Role in Risk Oversight

- Disclose the board's role in the risk oversight of the company
  - How does the board administer its risk oversight function?
  - What effect does this have on the board's leadership structure?
- Form of the required disclosure not specified by the new rules
- In contrast with existing SEC requirements concerning disclosure of effectiveness of disclosure controls and internal financial controls, new rule does not require
  - that any risk assessment be conducted
  - disclosure of the results of any risk assessment conducted
  - any related officer certification of effectiveness of risk oversight program at minimizing risk

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## Fees Paid to Comp Consultants



- Disclose fees paid to compensation consultants, where the consultants or their affiliates provided substantial services to the company (“non-executive compensation consulting services”) in addition to advice or recommendations on the amount or form of executive and director compensation (“executive compensation consulting services”)
- Disclose the aggregate fees paid for executive compensation consulting services and for non-executive compensation consulting services
- No fee disclosure for any compensation consultant which rendered non-executive compensation consulting services in an aggregate amount of less than \$120,000 during the last completed fiscal year
- No requirement to disclose nature and extent of the non-executive compensation related consulting services rendered by the consultant

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## Fees Paid to Comp Consultants



### Disclosure required in two scenarios

- Compensation consultant was engaged by the compensation committee to provide executive compensation consulting services as well as non-executive compensation consulting services
- Compensation committee has not engaged a compensation consultant, but management has engaged a compensation consultant to provide executive compensation consulting services, and management’s compensation consultant provides non-executive compensation consulting services to the company

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## Fees Paid to Comp Consultants

- No disclosure of compensation consulting fees if compensation committee and management have engaged separate consultants, even if management's consultant provides non-executive compensation consulting services to the company, and even if management's compensation consultant participates in board meetings
  - less potential for a conflict of interest where the board retains its own compensation consultant which reports to the board

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## Fees Paid to Comp Consultants

- No disclosure of compensation consulting fees if compensation committee has engaged a compensation consultant whose only role is to consulting on:
  - broad-based plans that do not discriminate in scope, terms, or operation, in favor of executive officers or directors of the company, and are available generally to all salaried employees
  - providing information, such as a survey, 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 compensation consultant does not provide advice

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## Reporting of Shareholder Meetings

### **New Form 8-K requirement to report results of shareholder meetings and actions by written consent**

- New rule applies to all shareholder meetings that end, and actions by written consent taken, after February 28, 2010
- Four business day deadline runs from end of meeting or action by consent
- If final voting results are not known, file Form 8-K with preliminary voting results within four business days of end of meeting, and then file amended Form 8-K within four business days after the final voting results become known.

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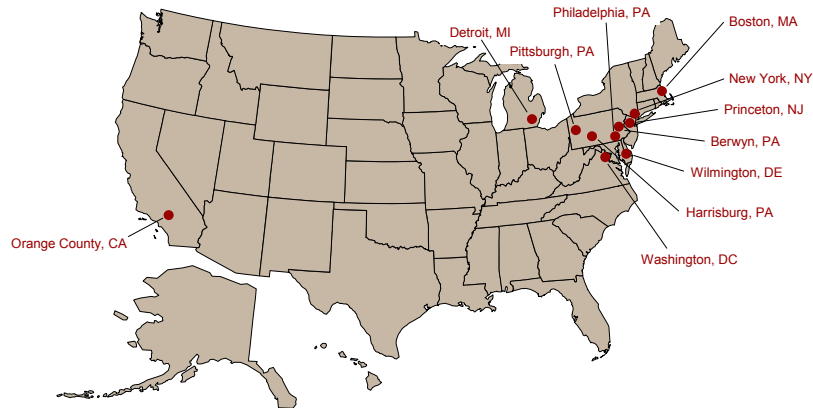
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