

SEC Requires New Compensation, Governance and Risk-Related Disclosures

December 2009

On December 16, 2009, the Securities and Exchange Commission (the "SEC") released extensive new disclosure rules that are intended to provide investors with more information about compensation practices, corporate governance and risk oversight within public companies. The new rules had initially been proposed by the SEC in July 2009 and were summarized in our Securities Law Update accessible at http://www.burnslev.com/apps/uploads/publications/SEC_Compensation_Govern_Disclosure_Aug09.pdf.

The new rules require public issuers and investment companies to make new or revised disclosures in proxy statements, public offering documents and required periodic reports regarding:

- Compensation policies and practices that are reasonably likely to have a material adverse effect on their companies;
- Stock and option awards to their executives and directors;
- The qualifications of their directors and nominees and the past legal proceedings in which they were named;
- The leadership structures of their boards of directors;
- The roles of their boards with respect to risk oversight; and
- Certain potential conflicts of interest for compensation consultants who advise their boards.

The new rules also require issuers and investment companies to disclose shareholder voting results in a more timely fashion on Form 8-K rather than waiting for quarterly or annual filings.

"By adopting these rules, we will improve the disclosure around risk, compensation and corporate governance, thereby increasing accountability and directly benefiting investors," said SEC Chairman Mary L. Schapiro.

It is clear from the SEC release and related investor comments that risk-taking in recent years related to derivatives, mortgage-backed securities and collateralized debt obligations was part of the impetus behind the new rules.

The expansive new rules, as explained below in more detail, require:

- A new discussion of a company's compensation policies or practices as they relate to risk management and to incentives that encourage risk-taking;
- A different method of disclosing stock and option awards based on their "aggregate grant date fair value" rather than dollar amounts recognized for financial statement purposes;
- New disclosures concerning qualifications of directors and nominees and the reasons they should serve as directors;
- Additional disclosures of directorships previously held by directors and nominees;
- Additional disclosures of legal actions involving a company's executives, directors and nominees;
- New disclosures regarding the consideration of diversity in the process of director nomination;
- New disclosures about a company's board leadership structure;
- New disclosures about the board's role in risk oversight;
- New disclosures about fees paid to compensation consultants and their affiliates under certain circumstances; and
- More prompt disclosure of shareholder voting results on Form 8-K rather than Forms 10-K or 10-Q.

SEC Commissioner Luis A. Aguilar called particular attention to the unprecedented

step of "aiding an investor's ability to assess a company's commitment to developing and maintaining a diverse board."

In doing so, he noted that roughly 90 percent of all letters submitted to the SEC regarding the proposal to mandate diversity-related disclosures about the board of directors were in favor of such disclosures. "When such a sizeable portion of the U.S. capital markets tells the Commission that they seek diversity-related information for their decisions, it is clearly material," he stated.

Effective Date: The effective date of the new rules is February 28, 2010. In a Compliance and Disclosure Interpretation issued December 22, 2009, the SEC outlined the following (which was not included in the December 16, 2009 rules release and was causing a significant amount of confusion): If the issuer'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 such an issuer 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 such an issuer 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. If the issuer'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.

Also, it is important to note that companies providing Regulation S-K Item 402 ("Executive Compensation") disclosure for a fiscal year ending on or after December 20, 2009 must present recomputed disclosure

for each *preceding* year required to be included in the Summary Compensation Table so that stock and option awards are shown based on the newly applicable full grant date fair values.

If a new registrant first files its registration statement (e.g., IPO registration statement or Form 10) on or after December 20, 2009, then compliance with these amendments would be required for the registration statement to be declared effective for any period on or after February 28, 2010.

For the full text of the rules, see SEC Release No. 33-9089 available at <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

Except as otherwise specified, the rules apply to all public companies and to all investment companies covered by the Investment Company Act of 1940.

RISKS PERTINENT TO COMPENSATION POLICIES AND PRACTICES

The new rules require a company to discuss and explain its compensation policies and practices for all employees, including non-executive officers, if those policies and practices create risks that are “reasonably likely” to have a material adverse effect on the company.

This requirement is not a part of the Compensation Discussion & Analysis (“CD&A”), as initially proposed, but is part of a new separate disclosure under Item 402(s) of Regulation S-K.

The SEC acknowledged that risk-related situations triggering disclosure requirements would vary from company to company under the announced standard, but offered some examples where compensation practices or policies might need to be discussed in pertinent filings:

- For a business unit of a company that carries a significant portion of the company’s risk profile;
- For a business unit with compensation structured very differently than other units;
- For a business unit that is significantly more profitable than others within a company;
- For a business unit where the compensation expense is a significant

percentage of the unit’s revenues; and

- For situations where overall risk and reward might be disproportionate, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task is spread over a future period of years.

The SEC also provided specific examples of issues that companies might need to address if they do decide that disclosure of compensation policies and practices is required because of adverse risks. Such issues, said the SEC, include:

- The general design philosophy of a company’s policies and practices for employees whose behavior would be most affected by incentives.
- A company’s risk assessment in structuring compensation policies and practices.
- Any policies directed at realization of risk over time, such as the imposition of compensation claw-backs or stock/option holding periods.
- Any policies regarding adjustments to compensation based on risk profiles or changes in risk profiles.
- The extent to which a company monitors its compensation policies and practices to determine whether its risk management objectives are being met.

Generic or boilerplate disclosures that incentives are designed for positive effect or that incentive compensation levels might be necessary to attract or retain employees will not be acceptable, the SEC added.

Because smaller reporting companies with a public float of less than \$75 million were not required to provide any CD&A originally, the SEC will not be requiring them to provide these new disclosures about risk and compensation.

REVISIONS TO SUMMARY COMPENSATION TABLE

Under the new rules, the Summary Compensation Table and Director Compensation Table must disclose the aggregate grant date fair value of the awards (computed in accord with Financial Accounting Standards Board Accounting

Standards Certification Topic 718). This standard requires calculation and disclosure of the awards based on the probable outcome of the performance conditions as of the grant date, and reflects the SEC’s belief that aggregate grant date fair value disclosure better reflects the compensation committee’s decision with respect to stock and option awards.

To provide investors with information about an award’s potential maximum value, the rules also require a footnote disclosure of the maximum value assuming the highest level of performance.

Disclosure is required for awards granted *during* a relevant fiscal year and not for awards granted *relevant* to a fiscal period but after its closing. The SEC said that companies should continue to analyze in CD&A any decisions to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of compensation.

To facilitate year-to-year comparisons, the rules also require companies providing Item 402 disclosure for a fiscal year ending on or after December 20, 2009 to present recomputed disclosure for each preceding year required to be included in the Summary Compensation Table.

DISCLOSURES FOR DIRECTORS AND NOMINEES

The SEC added or modified a number of disclosure requirements regarding directors and nominees for director positions, based on its belief that the amendments will provide investors with more meaningful disclosure that will help them in their voting decisions by better enabling them to determine whether and why a director or nominee is an appropriate choice for a particular company.

1. Qualifications

Under the amended rules, companies are required to disclose for each director and any nominee the particular experience, qualifications, attributes or skills that the board relied upon in concluding that the person in question should serve as a director for the company.

The same disclosure is required for any nominee put forth by a proponent other than the board.

Furthermore, the new disclosure is required for all nominees and directors, including those not up for re-election in any given year.

The SEC did, however, reject a proposal to require disclosure of the experience, qualification or skills that make someone a viable candidate for appointment to a *committee* of the board.

2. Past Appointments to Director Positions

Item 401 of Regulation S-K (“Directors, Executive Officers, Promoters and Control Persons”), prior to amendment, required only disclosure of any current director positions held by each director and nominee. The new rules require that directors and nominees disclose all directorships they have held at public companies or registered investment companies at any time during the past five years.

3. Past Legal Proceedings

The SEC similarly mandated that companies will have to disclose the legal proceedings involving directors and nominees that have occurred during the past ten years, rather than the current requirement of five years.

Furthermore, the list of legal proceedings to be disclosed has expanded. New legal proceedings that must be disclosed include:

- Any judicial or administrative proceeding resulting from involvement in mail fraud, wire fraud, or fraud involving any business entity.
- Any judicial or administrative proceeding based on violation of federal or state securities, commodities, banking or insurance laws and regulations.
- Any disciplinary sanctions or orders imposed by a stock, commodities or derivative exchange or other self-regulatory organization.

4. Diversity

The new rules also require disclosure of:

- Whether a nominating committee considers diversity in identifying nominees for directorships;
- How such a committee considers diversity;
- How any diversity policy, if one exists, is implemented; and

- How the nominating committee assesses the effectiveness of such a policy.

For purposes of complying with this disclosure requirement, companies will be allowed to define diversity in ways that they consider appropriate, the SEC said.

BOARD LEADERSHIP AND RISK OVERSIGHT DISCLOSURES

In pronouncing new disclosure rules concerning leadership structures and risk oversight responsibilities for boards of directors, the SEC reiterated that corporate governance practices are of critical interest and relevance to investors.

1. Leadership Structures

Under the amended rules, a company is required to disclose whether and why it has chosen to combine or separate the chief executive officer and board chairman positions. A company must also disclose whether and why a lead independent director has been appointed to chair meetings of independent directors, as well as the specific role that the lead independent director plays in the leadership of the company.

2. Risk Oversight

The SEC stated that risk oversight is a key competence of the board, and noted that companies must be prepared to deal with credit risk, liquidity risk and operational risk at the same time.

Thus, the final rules require that companies describe the board’s role in oversight of risk generally. The requirement gives companies flexibility to describe how the board administers any risk oversight function, whether through the board as a whole or through and audit or risk committee(s).

The SEC also suggested that where relevant, companies might want to address whether the individuals who supervise day-to-day risk management report directly to the board or to a board committee, as well as how the board or committee receives risk-related information from such individuals.

DISCLOSURES ABOUT COMPENSATION CONSULTANTS

The amount of fees charged by compensation consultants and the provision of any additional services by them to any company

could call into question the objectivity of the consultant’s advice and recommendations on executive compensation, the SEC noted.

Thus, there are a number of new disclosure requirements relating to compensation consultant engagements that supplement the existing requirement to describe the role of compensation consultants in determining or recommending any amount or form of executive/director compensation. The SEC also announced certain exemptions from disclosure. Both the required disclosures and exemptions are summarized below.

1. When the Board Engages Its Own Compensation Consultant

If the board, compensation committee or other designated group has engaged its own consultant to provide advice on the amount or form of executive compensation and if that consultant (or its affiliates) provides other non-executive compensation consulting services, then disclosure of all fees paid to the consultant for that year is required.

Disclosure in this case is also required of whether the decision to engage the compensation consultant or its affiliates (for non-executive compensation consulting) was made or recommended by management and whether the board has approved these services.

2. When the Board Does Not Engage Its Own Consultant

If the board or its designated group does not engage its own consultant, then disclosure of all fees paid to the consultant for that year is required if the consultant is providing both executive and non-executive compensation consulting services.

3. When the Board and Management Have Different Compensation Consultants

Neither fee-related disclosure or other disclosure pertinent to compensation consulting is required where the board has retained its own consultant that reports directly to the board and management has engaged a separate consultant to provide executive compensation consulting and any other compensation consulting services. The SEC suggested that the hiring of separate consultants by the board and management should greatly mitigate concerns about conflicts of interest for the consultants.

4. Minimum Threshold for Fee Disclosure

In all cases, fees paid to compensation consultants or their affiliates must be disclosed only if the aggregate fees paid for the non-executive compensation consulting services exceed \$120,000 for the company's relevant fiscal year.

5. Disclosure Not Required for Consulting Only on Broad-based Plans

The SEC also adopted an exception from compensation consultant disclosure requirements for situations in which the compensation consultant's only role pertinent to executive/director compensation is in connection with broad based plans that do not discriminate in favor of executive officers or directors.

This exception also includes situations where the compensation consultant's services are limited to providing information, such as survey information, that is not customized to the company or that is customized based on parameters not developed by the consultant.

6. Disclosure of Nature and Extent of Additional Services Not Required

The SEC rejected its own proposed requirement to disclose the nature and extent of additional services provided by the compensation consultant and its affiliates. Public commenters persuaded the SEC that such disclosure would cause competitive harm.

Explanatory Notes:

This update is intended to call your attention to a number of rule changes of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes or want to learn more about our expertise in this area.

REPORTING SHAREHOLDER VOTING RESULTS

New Item 5.07 to Form 8-K ("Submission of Matters to a Vote of Security Holders") requires companies to disclose the results of shareholder votes on a Form 8-K within four business days after the end of the meeting at which the vote was held, rather than wait for the next Form 10-Q or 10-K following the meeting. The new rules apply to any shareholder meeting that takes place on or after February 28, 2010.

In situations where it may take a longer period to determine the definitive outcome of a shareholder vote, companies are required to file preliminary results within four business days and then file an amended Form 8-K within four business days after the final voting results become known.

Burns & Levinson's Securities Law Group represents public and private companies, underwriters and investment banks, venture capital and investment funds, real estate investment funds, investment advisors, broker-dealers, stockholder groups and individuals in public and private securities offerings and transactions, SEC, FINRA and stock exchange compliance, corporate governance, fund formation and offerings, SEC enforcement and securities litigation.

THE SECURITIES LAW GROUP

Josef Volman - Co-Chair
617.345.3895 | jvolman@burnslev.com

Andrew Merken - Co-Chair
617.345.3740 | amerken@burnslev.com

If you have any questions regarding this Burns & Levinson Securities Law Update, please contact one of the individuals named above.

If you would like to be added to or removed from the mailing list for Burns & Levinson Securities Law Updates or other Burns & Levinson publications, please call 617.345.3000 or send your name and email address to clientservices@burnslev.com.

ABOUT BURNS & LEVINSON'S SECURITIES LAW GROUP

Burns & Levinson's attorneys have extensive experience representing public and private issuers, stockholder groups and individual investors. Our attorney team counsels clients on IPOs and follow-on offerings of equity, debt and other securities (including shelf registration takedowns), corporate acquisitions involving registered and restricted stock, mergers and acquisitions where one or both parties are publicly traded, private investment in public equity (PIPE) transactions, private placements, venture capital financings, and complex securities law transactions and issues, including corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance.

In the securities compliance area, we advise our clients on corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance. Specifically, we assist our clients in fulfilling their ongoing SEC and stock exchange reporting obligations, managing sensitive disclosure issues internally and with industry analysts, preparing proxy statements and handling stockholder meetings, structuring employee benefit plans and executive compensation packages under the SEC's "short-swing profit" reporting and liability rules, effecting resales of securities in the public trading markets under

the SEC's Rule 144, and advising boards of directors and board committees concerning the requirements and restrictions imposed on their actions by the securities laws and corporate governance laws such as Sarbanes-Oxley. We have served as special securities counsel to the Boards and Audit Committees of publicly traded companies looking for opinions or advice of counsel other than their regular outside counsel.

We have counseled clients both domestic and international, from emerging growth companies to large public companies, and are positioned to provide clients with timely, expert, efficient and cost effective advice that they need to meet their business objectives. We take a practical and proactive approach to the rapidly changing securities disclosure and corporate governance laws, providing our clients with timely updates, identifying specific situations in which the new laws will impact particular clients either operationally or structurally, and working with clients to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

Underwriters and Investment Banks

Our attorneys also represent underwriters in initial and follow-on public offerings and investment banks in private placements and mergers and acquisitions.