RADFORD ALERT

SEC Adds New Compensation Disclosures Requirements

New Rules Require Companies to Assess Risks of Compensation Practices, Report Equity Grant Values Differently and Disclose Consultant Relationships

On December 16, 2009 the Securities Exchange Commission (SEC) expanded the disclosure rules it originally laid down several years ago, adopting several new regulations related to executive compensation and board structure. The new regulations pertain to the relationship between public company compensation policies and the potential risks engendered by those policies, the qualifications and relationship of the board to management, how equity values are reported, and the relationship between companies and the compensation consultants they retain (see Figure 1). This Radford Alert provides an overview of the new rules, as well as our perspective on the impact to clients.

Figure 1: Regulation Impact At-A-Glance

Rule	Changes	Company Impact
Compensation Policies and Company Risk	Requirement to disclose and discuss compensation policies/practices for all employees if they create risks that are reasonably likely to have a material, adverse effect on the company.	• Companies will assess their compensation policies against SEC's guidelines for their *reasonable likelihood* of having a materially adverse effect on the company • Companies must disclose where they have determined the likelihood of an adverse outcome exists
Summary Compensation Table	Requirement to report aggregate grant date full value for disclosing current year grants (rather than amount expensed) in Summary Compensation Table and Director Compensation Table	• Simplifies reporting in the Summary Compensation Table and Directors Compensation Table o Performance awards value pegged to target performance • Could alter the list of Named Executive Officers
Board Structure	Additional information on both the composition of the board and its relationship to management	• Companies must explain the qualifications of board members, how members are selected and the rationale behind their governance structures

Compensation Consultant Relationships	Increased disclosure of relationship with executive and/or board compensation consulting company	• Disclosure required if a compensation consultant provides services to both the board and management, where fees exceed $120,000 • If the board has its own consultant, no fee disclosure is required

Risk Assessment and Reporting

One of the fundamental drivers of the new proxy rules is the SEC view that a portion of the financial "melt down" of 2008/09 was driven by compensation policies that encouraged "excessive" risk-taking on the part of some employees (not just Named Executive Officers (NEOs)). To provide shareholders with more information regarding the *potential* risks inherent in compensation programs, the new rules call for a company to "address its compensation policies and practices for all employees, including non-executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company."

This is an improvement over the originally proposed language in several respects. First, it only requires a discussion *when there is a reasonable likelihood* of there being a material adverse effect on the company, as opposed to the original proposal which required commentary regardless of the level of impact. Second, disclosure is required only for *material adverse* effects, instead of any effect. The bottom line, at least for the majority of our technology and life science clients, is that this will have a minimal impact on disclosure. Reviewing the range of examples in the release (although not an exclusive list), the SEC is focusing on those situations where:

> A business unit has a substantial portion of the company's business risk

> The pay in a business unit is substantially different from that of the rest of the company

> Where compensation is tied to qualitatively different metrics and can comprise a substantial portion of the revenue of the business

Historically technology and life science companies have not had these types of compensation plans, therefore we believe that this section of the regulations will be mostly applicable to financial services companies. However, where a company has business-specific pay schemes, the assessment of risk must be included in the disclosure.

For those companies that will go through the disclosure process, the SEC provided examples of the issues that might need to be addressed, including:

> The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives

> The company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation

> How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods

> The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile

- Material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile

- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees

Radford Assessment: With proxy advisor RiskMetrics Group's recent adoption of similar requirements for disclosure of risk assessments, this ruling was expected. Generally speaking, technology and life sciences companies do not rely on the types of incentive practices most under scrutiny (large, short-term cash bonus opportunities) with these new rules.

Summary Compensation Table

With respect to stock options and stock awards, the SEC now requires that the grant date fair value of options and stock awards issued during the year be reported. While the move should in some ways simplify the reporting process for companies, there is also a chance that the new method of value calculation could precipitate a change in the company's Named Executive Officers.

The SEC made one adjustment to its originally proposed change by stipulating that the value of performance-based awards be tied to an assumption of target performance, rather than the maximum possible award under the plan, which will be reported in a footnote.

Radford Assessment: The revised reporting requirement will help to better illustrate the compensation executives actually received during the year and avoid some of the distortions of disclosing values recognized for financial reporting purposes. Companies will likely find compliance with reporting requirements eased by these changes. Companies may find that their NEO determination is affected by this change. A preliminary evaluation of how the new rule will impact the positions included as an NEO should be assessed immediately in preparation for the proxy season.

Enhanced Director Disclosure and Risk Oversight

The new rules require companies to provide additional disclosure regarding their directors, from several perspectives:

1. Companies are required to disclose for each director and director nominee the experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director. This rule applies not just to nominees, but to continuing directors as well. Unfortunately, the SEC does not give guidance on the details, rather they note: "The final amendments do not specify the particular information that should be disclosed. We believe companies and other proponents should be afforded flexibility in determining the information about a director's or nominee's skills, qualifications or particular area of expertise that would benefit the company and should be disclosed to shareholders. However, we note that if particular skills, such as risk assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board or proponent to conclude that the person should serve as a director, this should be disclosed." The bottom line is that companies will now have to provide some rationale for the selection and nomination of specific directors. The SEC did, however, eliminate the initial proposal that would extend this rationalization to committee selection as well.

2. Disclosure of other directorships has been expanded to cover the previous five years.

3. Disclosure for legal proceedings has been expanded from five years to ten years, as well as broadening the range of proceedings that must be disclosed, to include:

    a. Any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;

b. 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

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

4. Companies will be required to disclose to what extent they consider "diversity" in selecting directors, and whether the nominating committee has a specific policy regarding diversity. The SEC is allowing companies to determine for themselves how they will define diversity.

In order to highlight the role of the board in providing corporate oversight with regard to business risk, the SEC is requiring more complete disclosure with regard to the board leadership structure – Chair, CEO, Lead Directors – and the company is required to disclose whether and why it has chosen to combine or separate the principal executive officer and board chairman positions, and 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. In addition, in some companies the role of principal executive officer and board chairman are combined, and a lead independent director is designated to chair meetings of the independent directors. In these circumstances, the amendments require disclosure of whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company.

With regard to the specific management of risk – investment risk, business risk, etc., the disclosure requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee. Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee, or how the board or committee otherwise receives information from such individuals. In effect, companies will have to explain to shareholders how the board both keeps abreast of potential corporate risks, and how it manages those risks at the governance level.

Radford Assessment: The nominating and governance committee will need to review the board structure and develop its rationale for specific roles to both clarify roles and responsibilities, and to document the thinking behind the board structure.

Compensation Consultant Relationships

The SEC has adopted additional disclosure rules for companies regarding their compensation consultants, which require different types of disclosure, depending on the amount of fees the company pays, who engages the consultant and what other work the consultant provides for the company.

These rules can be broken out as follows:

- If a consultant is engaged by the board and provides more than $120,000 of non-executive consulting services, the company must disclose the aggregate fees for services provided

- Disclosure is also required as to whether the decision to engage the compensation consultant was made or recommended by management, and whether the board has approved any non-executive compensation consulting services provided by the consultant or its affiliate

- If the board has not engaged its own consultant, fee disclosures are required if there is a consultant providing executive compensation consulting services and non-executive compensation consulting services to the company, provided the fees for the non-executive compensation consulting services exceed $120,000 during the company's fiscal year

- Fee and related disclosure for consultants that work with management is not required if the board has its own consultant

Radford Assessment: The SEC attempted to strike a balance between providing investors insight into perceived potential conflicts of interest and the competitive harm that could be done in so doing. Both the $120,000 threshold for triggering disclosure and the distinction made for non-discriminatory plan services serves to approach this balance. However, companies impacted by the threshold for disclosure will need to articulate the rationale behind the hiring of their consultants in order to avoid the appearance of conflict.

What Does It All Mean?

In a nutshell, companies will have substantial additional work ahead of them for the next proxy season. This work will fall into three areas:

1. *Policy capturing* – In some instances, companies will have to formally capture and document policies that heretofore have been either implicit or only considered holistically. "What are the specific criteria used in director selection?" "Why do we have a lead director rather than a non-executive chair?" "How does the board (or the audit committee) deal with risk assessment?" "Do we need a separate "risk committee"? These are the types of issues that companies and their board will need to consider, and document, before they file their next proxy statements. This work will fall both on the board and management – the former to formulate their policies, the latter to ensure that everything is properly documented.

2. *Data gathering* – The new rules require several new (or revised) pieces of data be reported in the proxy. First, companies will need to re-cast their stock compensation in the summary tables to reflect grant-date accounting costs, rather than the costs incurred annually over vesting. Second, additional information will need to be collected from the individual directors to ensure that the expanded director reporting is satisfied. Third, companies (and their consultants) will need to document both their fees and the purpose of those fees to ensure that the consultant disclosure is accurate. Finally, companies will need to document policies that guide their consultant selection processes.

3. *Proxy writing* – Several sections of the existing proxy will need to be revisited, and in some cases, significantly rewritten. To the extent that a company has special compensation programs for certain groups/divisions (and potentially sales people as well, if the amounts are significant enough), they may need to add a new section specifically addressing the risk issues involved in their compensation plans. The director nomination and continuing director sections will need to be expanded to provide a discussion of how directors are selected and what specific attributes they bring to the table for the company, as well as broader issues such as director diversity, determination of the structure of the board leadership and how the board deals with issues of risk. Finally, the CD&A will need to include additional information on the selection, use and compensation of the consultants the board retains.

Timing of Rule Adoption and Implementation

These changes are in effect as of February 28, 2010. A copy of the rules can be found at http://www.sec.gov/rules/final/2009/33-9089.pdf.

More Information

We encourage you to forward this Alert to your board members. And as always, we encourage you to contact us if you have questions. For more information, contact:

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