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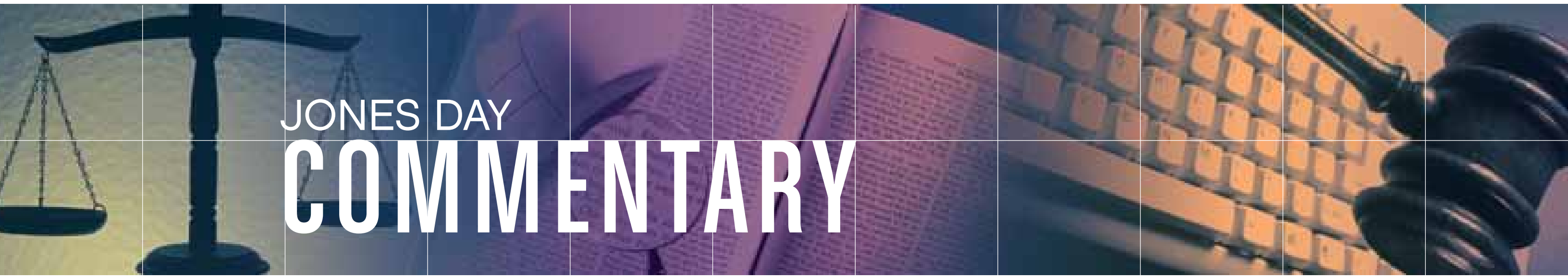

PROPOSED CHANGES TO PROXY DISCLOSURE REGARDING EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE

On July 10, 2009, one month following the statement issued by Chairman Mary Schapiro of the Securities and Exchange Commission (the "SEC" or the "Commission") that the Commission was considering enhanced compensation and other proxy statement disclosure requirements for all public companies,[1] the SEC issued proposed amendments to its compensation and corporate governance disclosure rules.[2] The proposed amendments are intended to enhance compensation and corporate governance disclosure by requiring "better or more timely disclosure—not simply additional disclosure."[3] The Commission has indicated that the proposed enhanced disclosure amendments are, in part, to continue to "assist investors' ability to make more informed voting and investment decisions"[4] by improving the presentation of information disclosed.

Although many of the proposed amendments are generally intended to provide investors with greater breadth and depth in the compensation and corporate governance disclosures of public companies, the SEC recognizes that there are many complex disclosure issues raised by the proposed amendments and is requesting comments. The SEC also indicated that it "is exploring other ways in which [it] could improve proxy disclosures"[5] and is requesting comments on alternative measures that might lead

1. Chairman Mary Schapiro on Executive Compensation, press release issued June 10, 2009.
2. *See* SEC Release Nos. 33-9052 and 34-60280 (July 10, 2009), Proxy Disclosure and Solicitation Enhancements.
3. Speech by SEC Chairman: Statement at SEC Open Meeting on July 1, 2009.
4. SEC Release Nos. 33-9052 and 34-60280 (July 10, 2009), p. 4.
5. *Id.* at p. 63.

to improved compensation-related proxy statement disclosure, including whether: (i) certain disclosures should apply to all executive officers (not just named executive officers); (ii) the instruction allowing companies to exclude disclosure of performance targets for competitive harm reasons should be eliminated; and (iii) companies should be required to disclose "hold to retirement" and/or clawback provisions. Comments must be received on or before September 15, 2009. If adopted, the proposed amendments are anticipated to be effective for the 2010 proxy season.

This *Jones Day Commentary* highlights some of the key areas affected by the proposed amendments.[6]

COMPENSATION RISK ANALYSIS

Summary of Proposed Amendments. Some critics have argued that the recent market turmoil resulted in part from companies' incentive compensation policies and arrangements that encouraged "risky" behavior by creating incentives for employees to make business decisions without giving careful consideration to the potential long-term effects of such decisions. In response to these critics, the increasing complexity of executive compensation arrangements, as well as the directive to "protect investors" by ensuring access to meaningful information, the Commission has proposed amendments designed to provide investors with disclosure that discusses the relationship between a company's overall compensation policies and risk. In particular, the proposed amendments would require companies to discuss how broad-based compensation policies and overall compensation practices for all employees could affect risk, to the extent the "risks arising from those compensation policies and practices may have a material effect on the company."

The SEC recognizes that the types of situations that would warrant some level of risk disclosure will vary among companies based on the specific facts and circumstances. Companies will need to evaluate how their incentive compensation structures might encourage employees to take on varying degrees of risk in efforts to achieve those incentives. Examples of circumstances where a company's compensation policies and practices could trigger discussion and analysis identified in the proposed amendments include compensation policies and practices:

- at a business unit carrying a significant portion of the company's risk profile;
- at a business unit for which the compensation structure is significantly different from that of the company's other business units;
- at a business unit that is significantly more profitable than the company's other units;
- at a business unit for which compensation expense represents a significant percentage of revenues; or
- that vary significantly from the company's overall risk and reward structure, (*e.g.*, rewarding accomplishment of a task in the short-term where the impact on the income of and risk to the company extend over a longer term).

The proposed amendments suggest that disclosure also could be warranted in circumstances where a company's compensation policies, practices, and structure could have a material impact on the company, including a discussion of the following:

- the design and implementation of a company's philosophy behind its compensation policies for those employees whose potential risk-taking behavior would be most affected by the incentives established by the policies;
- any risk assessments or incentive considerations given in establishing the structure of the company's compensation policies or awarding and paying compensation;
- how the company's compensation policies may relate to risks realized as a result of employees' actions in both the short and long term (*e.g.*, clawback or holding period policies);

6. The proposed amendments would also provide clarity and address various questions that have arisen in connection with the rules governing the proxy solicitation process.

- a company's policies regarding making adjustments to compensation policies to address any changes in a company's risk profile and any material modifications made to its compensation policies or practices as a result of such changes; and
- the extent to which a company monitors its compensation policies to determine whether its risk management objectives are being met with respect to employee incentives.

Initial Observations. The compensation committee of a company participating in the Troubled Asset Relief Program ("TARP") is now required to discuss and disclose how the compensation plans for the company's senior executive officers do not encourage (i) excessive risk-taking behaviors that "threaten" the company's value; (ii) manipulation of reported earnings to enhance compensation; or (iii) behavior that focuses on short-term results instead of long-term value creation. The committee also must identify risks created by employee compensation plans and steps taken to minimize those risks.[7] With the proposed amendments, public companies also now may be required to discuss similar issues, including the relationship of risk to their compensation policies and practices, in the Compensation Disclosure and Analysis ("CD&A").[8] Recognizing that disclosure should be meaningful to investors, the SEC is seeking comment on whether disclosure should be limited to companies of a particular size, in certain industries, or to certain employee groups (*e.g.*, executive officers).

Pending final action on these proposals, companies should undertake a review of their compensation policies and practices to assess how they may relate to or affect risk management. For some companies (more than others), it may be a more challenging task to identify and evaluate those relationships, however. Consideration will need to be given to how such policies and practices could be viewed as encouraging risky behavior by employees in order to achieve incentive compensation targets. A deliberate process should include determining which board committees (in addition to the compensation committee) and corporate officers should be involved. After completion of this process, a company may reasonably determine that any risks created by or arising from its compensation practices and policies should not have a material effect on the company, and that no disclosure is therefore warranted. However, boards and management should be mindful that an affirmative statement may be required. The SEC is also requesting comment on whether companies that make such a determination should be required to affirmatively state in their CD&As that any risks arising from broad-based compensation policies are not reasonably expected to have a material effect on the company.

REVISIONS TO REPORTING OF OPTIONS AND OTHER EQUITY AWARDS

Summary of Proposed Amendments. The proposed amendments would require full grant date FAS 123(R) fair value reporting of options and other equity awards granted during the applicable fiscal year in the Summary Compensation and Director Compensation Tables. Recognizing that disclosure of the grant date fair value of equity awards in the Grants of Plan-Based Awards Table and in the footnote disclosure to the Director Compensation Table may be duplicative of the new full grant date fair value disclosure requirement being proposed, the proposed amendments would eliminate that disclosure. The proposed change essentially would revert back to the disclosure format for options and other equity awards in effect prior to the SEC's adoption of the current disclosure requirements for such awards in December 2006. As proposed, the amendments would not require companies to report in the salary and bonus columns of the Summary Compensation Table, salary or bonus amounts forgone at a named executive officer's election. Instead, companies would

7. A summary of the compensation and governance standards implementing the compensation standards mandated by the Emergency Economic Stabilization Act of 2008, as modified by the American Recovery and Reinvestment Act of 2009 for TARP recipients, is provided in the *Jones Day Commentary* "TARP Compensation Guidance and Other Executive Compensation Proposals," June 2009.

8. The SEC is requesting comment on whether smaller reporting companies should be required to provide disclosure on their overall compensation policies as they pertain to risk management. Smaller reporting companies are currently excluded from the requirement to provide a CD&A.

be required to reflect the substituted non-cash awards elected to be received by the executive in the column applicable to the type of award selected.

Initial Observations. Since adoption of the SEC's current executive compensation disclosure rules in 2006, the SEC, companies, and their advisors have wrestled with the issue of what is the "proper" disclosure for options and other equity awards in the compensation tables, including: (i) disclosure of the grant date fair value of equity awards in the Grants of Plan-Based Awards Table (*e.g.*, whether such an amount should be reported at a target or maximum level) and (ii) disclosure of negative dollar amounts, recognized for financial statement reporting purposes, in the stock awards and option awards columns of the Summary Compensation and Director Compensation Tables (which the SEC recognizes could create confusing, rather than better, disclosure).

Although the current disclosure rules for options and other equity awards were adopted primarily in response to the reality that amounts actually paid out for options and other equity awards may differ from the full grant date fair value, many observers have expressed the view that full grant date fair value reporting of equity awards may be the most useful disclosure format. The SEC is seeking comment on whether the Summary Compensation Table should report the full grant date fair value of equity awards not only for grants made during the relevant fiscal year but also for those made after the fiscal year-end for services in the relevant fiscal year. Further, the SEC has asked for feedback as to whether the scope of awards reported in the Grants of Plan-Based Awards Table should be changed to correspond to the final disclosure rules applicable to the Summary Compensation Table. The final determination of these issues by the SEC likely will be of significance to companies that pay out equity awards in the beginning of a year for services performed during the prior fiscal year.

The SEC recognizes that the proposed approach to this disclosure has the potential to distort the identification of named executive officers. For example, a one-time mega equity grant to an executive officer that would be earned over multiple years could cause the executive to be tagged as a named executive officer for disclosure purposes, even though the individual would not otherwise ordinarily qualify for such designation. The requests for comment on this topic appear to indicate a willingness on the part of the SEC to reconsider the impact and effectiveness of the current equity-based disclosure rules. It is clear that there is no single "right" answer, but it ultimately remains to be seen whether the proposals will in fact facilitate more informed "investment and voting decisions" as intended.[9]

DISCLOSURE RELATED TO POTENTIAL CONFLICTS OF INTEREST AFFECTING COMPENSATION CONSULTANTS

Summary of Proposed Amendments. To address perceived potential conflicts of interest affecting a company's compensation consultants,[10] the proposed amendments would require disclosure of certain additional information where the consultants provide both executive compensation and other services to the company. Information that companies would be required to disclose include: (i) the nature and extent of the additional services provided during the last fiscal year; (ii) aggregate fees paid for such services, as well as those paid for executive or director compensation services; (iii) management's role in engaging the consultant for non-executive compensation services; and (iv) the board of directors' or the compensation committee's role in approving non-executive compensation services.[11]

Initial Observations. Many companies already disclose the process by which their boards of directors and/or compensation committees are involved in the oversight of the

9. Apart from the proper disclosure debate, on July 22, 2009, Senators Carl Levin and John McCain introduced legislation, the Ending Excessive Corporate Deductions for Stock Options Act, S. 1491, that would amend Section 162(m) of the Internal Revenue Code to apply the $1 million deduction cap provision to stock options, as well as to limit the amount of a company's compensation deduction to the amount expensed by the company in the year the expense is recorded on the company's books.

10. The proposed amendments also would apply to affiliates of the compensation consultants.

11. The new disclosure requirements would not apply to a consultant if the only services it provides to a company pertaining to executive or director compensation matters is with respect to the company's broad-based plans (*e.g.*, 401(k) plans or health insurance plans, etc.).

companies' compensation consultants who also provide or are directed to provide services to or have significant contacts with management. However, other companies may need to consider whether a focused evaluation of the overall compensation consultant engagement and relationship should be conducted, including reporting relationships. The end result may be a determination that the compensation consultant should report exclusively to the board or compensation committee for all aspects of the engagement. There is clearly a balancing of interests and resources that must be considered.

On July 16, 2009, the Department of the Treasury presented draft legislation to Congress proposing standards for compensation committee independence and that of a committee's advisors, including proposed modifications to the Securities Exchange Act of 1934 that would authorize the SEC to establish independence standards for compensation consultants and other advisors.[12] The proposed legislation, in large part, was incorporated into a bill, the Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, introduced on July 21, 2009, by Congressman Barney Frank, Chairman of the House Financial Services Committee, along with other members of Congress, and approved by the House of Representatives on July 31, 2009.

COMPANY LEADERSHIP STRUCTURE

Summary of Proposed Amendments. The proposed amendments would require companies to disclose their leadership structure, including whether the positions of CEO and board chair are combined or separate and the rationale for the structure in place. If the positions are combined, the company would be required to disclose whether it has a lead independent director, and if so, the role of such director.

Initial Observations. Companies have been facing increased pressure from institutional shareholders and other corporate governance advocates to restructure board leadership by separating the roles of CEO and board chair. The disclosure requirements being proposed may be viewed by some as adding to that pressure, although the Commission acknowledges that one size does not fit all, noting that "different leadership structures may be suitable for different companies depending on factors such as the size of company, the nature of [its] business," internal control, and other considerations. As part of its overall corporate governance review, a company's board and senior management should continue to assess its chosen leadership structure to determine whether the existing structure continues to serve the company, its business goals, objectives, and long-term viability—given its history, culture, relationships, and other factors.

RISK MANAGEMENT BY THE BOARD OF DIRECTORS

Summary of Proposed Amendments. To address the notion that the current market turmoil was triggered in large part by a lack of adequate risk management and oversight by boards of directors, the proposed amendments would require companies to assess and discuss the manner in which the board of directors (or a committee) oversees and monitors the risk management process. Areas in which the Commission has indicated disclosure would be warranted include discussion of the following:

- the reporting obligations of the risk management personnel (*e.g.*, whether such individuals report directly to the entire board of directors, a specific committee (*e.g.*, audit), or another standing committee); and
- whether the entire board of directors (or a designated committee (*e.g.*, audit)) monitors risk and, if so, how such monitoring is conducted.

Initial Observations. "Enterprise Risk Management," a somewhat nebulous concept, has become a greater focus for institutional shareholders and other proponents of corporate governance reform. Companies should consider what,

12. Proposed Investor Protection Act of 2009.

if any, changes should be made to their risk management philosophies, polices, and processes in light of the proposed amendments and increasing pressures and concerns being raised by shareholders, both at the management and board levels.

ENHANCED DIRECTOR AND DIRECTOR NOMINEE DISCLOSURE

Summary of Proposed Amendments. To provide more information to shareholders about the qualifications of directors and director nominees, the proposed amendments would require expanded disclosure relating to director and nominee qualifications, including specific experience, qualifications, or skills that qualify an individual to serve on the company's board of directors (and any applicable committees), and any public company directorships held during the past five years.

These enhanced disclosure requirements (including expansion of disclosure of certain legal proceedings from five to 10 years) would apply not only to director nominees (whether nominated by the company or by investors), but also to incumbent directors. Additional areas identified for expanded disclosure include those that would address an individual's risk assessment skills, specific past experience that would be useful to the company, past directorships, particular areas of expertise, and discussion of reasons why the individual's service would benefit the company.

Initial Observations. If the proposed amendments are finalized, they may require the disclosure of information that may not be readily available. Therefore, companies should begin the information-gathering process as soon as possible, including revising any director questionnaires provided to directors and director nominees to capture any such additional information.

The SEC is seeking comment on whether the expanded disclosure requirements of a board member's qualifications should be extended to the members of all committees of a board (or limited to specific key committees (*i.e.*, audit, compensation, and nominating/governance committees)) to explain why an individual is qualified to serve on a given committee, as well as comment on whether this disclosure would be meaningful and useful to investors. Comment on the frequency of such disclosure is also being requested. The tenor of the SEC's request for comment regarding these expanded disclosure requirements indicates that the SEC may be willing to consider alternatives if geared toward providing more meaningful information to investors about a director's or director nominee's suitability to serve on a company's board.

REPORTING VOTING RESULTS ON FORM 8-K

Summary of Proposed Amendments. In response, in part, to concern that the delayed reporting of shareholder voting results on Form 10-Q or Form 10-K makes the information less useful to investors and the market, the proposed amendments would require voting results reporting on Form 8-K within four business days after the end of the applicable meeting. To the extent the results are related to a contested election, companies would be required to report the preliminary results on Form 8-K within four business days after such results are determined. An amended Form 8-K reporting final results would be required to be filed within four days following certification.

Initial Observations. The proposed filing deadline may be unrealistic in certain situations. In its request for comment, the SEC has raised the question of whether there are alternative methods by which this information could be disseminated to investors and the market, as well as requested feedback on whether other changes should be made to the requirements for reporting shareholder vote results. Internet disclosure on a company's web site of shareholder voting results could be an interim or alternative approach but with a focus on final rather than preliminary results. The SEC is also looking for comment on whether preliminary disclosure could influence final results and whether the proposed amendments would impose additional difficulties and significant costs either on a one-time basis or over the long term.

OVERALL INCREASED DISCLOSURE BURDEN

The proposed amendments may significantly increase the amount of information companies are required to generate and disclose, which may place additional pressures on the companies' resources to be able to appropriately and efficiently respond to the proposed amendments. If adopted, the Commission has stated that compliance likely would be required beginning with the 2010 proxy season, which may not allow for a substantial amount of time for the information gathering and analysis background work that will be necessary after publication of the final amendments in the Federal Register. Although the proposed amendments have not been adopted and the level of analysis and restructuring of existing structures, processes, and reporting will vary among companies, companies should begin to consider commencement of this process as soon as possible.

LAWYER CONTACTS

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