

Client Alert

SEC Issues Guidance on New Proxy Disclosure Rules

EXEQUITY

Independent Board and
Management Advisors

On January 20, 2010, February 16, 2010, and March 1, 2010, the SEC released updates to its Compliance and Disclosure Interpretations (C&DIs) concerning the new proxy disclosure rules and the transition to these rules.¹

C&DIs: Regulation S-K

The updated C&DIs for the new Regulation S-K disclosure rules address questions on director nominee disclosures, annual incentive and equity awards granted to executives, risk assessment narrative placement, and compensation consultant disclosures, and remove several interpretations that are no longer needed after February 28, 2010.

Directors

The disclosure of each director and nominee's "specific experience, qualifications, attributes or skills" cannot be provided on a group basis, even if the directors or nominees share similar characteristics. The SEC indicates that for each person, a company must disclose why the person's *particular* and *specific* experience, qualifications, attributes or skills led the board to conclude that such person should serve as a director, in light of the company's business and structure, at the time that a filing containing the disclosure is made. [Question 116.05]

The SEC further clarifies that such disclosure about directors and nominees should be made by companies with classified boards even for directors not up for reelection. [Question 116.06]

But, if a director's term of office will not continue after the meeting to which a proxy or information statement relates, companies are not required to include the business experience disclosure for such a director required by Item 401(e). [Question 116.07]

Annual Incentive Awards

An executive is awarded an annual incentive with no right to stock settlement embedded in the terms of the award. Such an award is treated as a non-equity incentive plan award. Subsequently, the executive elects to receive the payout in stock. In that case, the award is reported in the non-equity incentive plan award column of the Summary Compensation Table, with footnote disclosure of the stock settlement. In the Grants of Plan-Based Awards Table, the award also would be reported as a non-equity

¹ SEC Compliance and Disclosure Interpretations—Regulation S-K, available at: <http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm>; and Compliance and Disclosure Interpretations—Proxy Disclosure Enhancements Transition, available at: <http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm>

incentive plan award, and the stock received upon settlement should not be reported as that would double count the award. [Question 119.22]

However, the reporting is somewhat different if a company grants annual incentive awards to its named executive officers (NEOs), which permit the NEOs to elect payment of the award in company stock rather than cash during the first 90 days of the year, and one NEO elects to receive payment in stock. In that case, for the NEO who elected a stock payment, the award is reported in the Summary Compensation Table and Grants of Plan-Based Awards Table as an equity incentive award. This holds true even if the amount of the award is not determined until the early part of the following year because all decisions necessary to determine the value of the award were made in the year of performance for the annual incentive. For the other NEOs who receive cash payments for their annual incentive awards, their awards are reported in the Summary Compensation Table and Grants of Plan-Based Awards Table as a non-equity incentive plan award. [Question 119.23]

Equity Awards

If an executive officer is granted an equity award during the year but the award is forfeited in that same year because the officer left the company, the grant-date fair value of such award should be included for purposes of determining total compensation and identifying the NEOs for the year. [Question 117.04]

If a company chooses to report the grant-date fair value assumptions for equity awards in the Grants of Plan-Based Awards Table, it can simply reference that table to satisfy its disclosure obligations regarding the assumptions for equity awards included in the Summary Compensation Table. [Question 119.16]

The SEC Staff also clarifies that the provision in the instructions for the Grants of Plan-Based Awards Table that the value reported for equity awards subject to performance conditions should exclude the effect of estimated forfeitures also applies to awards subject to time-based vesting. [Question 119.20]

If an equity award is modified after grant such that there is some incremental fair value under FASB ASC Topic 718 (formerly FAS 123R), the incremental fair value would be reported in the Summary Compensation Table and be used for determination of NEO status in the year in which the grant or modification occurs. Thus, if an award is modified in the year it is granted, then the Summary Compensation Table will include *both* the grant date fair value of the grant and the incremental fair value of the award as of the date of modification. [Question 119.21]

Another piece of guidance addresses equity grants with multi-year performance periods where the grant date occurs at the end of the performance period (rather than the beginning) because all of the conditions for establishing a grant date under FASB ASC Topic 718 are not satisfied at the beginning of the performance period. Under FASB ASC Topic 718, the grant date and the service inception date (date performance of services begins) are usually the same. In order for the grant date and the service inception date to be the same, the following conditions must be satisfied:

- The employer and its employees have reached a mutual understanding of the award's key terms and conditions;
- The company is contingently obligated to issue shares or transfer assets to employees who fulfill vesting conditions;

- An employee begins to benefit from, or be adversely affected by, subsequent changes in the employer's stock price;
- Awards are approved by the board of directors, management, or both if such approvals are required, unless considered perfunctory; and
- If the award is for employee service, the recipient meets the definition of an employee.

If discretion can be exercised with respect to a performance-based award, it is possible that there may not be a mutual understanding of the award's key terms at the beginning of the performance period (the service inception date). In this case, the grant date for accounting purposes is when there is a mutual understanding, which is typically at the end of the performance period. However, for purposes of proxy disclosure, the award should be reported in the Summary Compensation Table and the Grants of Plan-Based Awards Table as compensation for the year in which the service inception date occurs. The amount reported in both tables would be the fair value of the award at the service inception date, based upon the then-probable outcome of the performance conditions. This same amount also would be used in determining NEO status. [Question 119.24]

Any "reload" stock options received by an executive must be reported as an option grant in the Grants of Plan-Based Awards Table and Summary Compensation Table, as would any other stock option grant. [Section 220.01]

Note: We recently asked the SEC Staff whether an equity award with a market condition (as defined under FASB ASC Topic 718), such as relative Total Shareholder Return, was subject to the footnote requirements to disclose the maximum amount payable for performance awards if the maximum was not included in the Summary Compensation Table. We were told that the SEC Staff views market-condition awards differently than performance-condition awards and, therefore, market-condition awards would not be subject to the footnote requirements of Instruction 3 to Item 402(c)(2)(v) and (vi), i.e., "In a footnote to the table, disclose the value of the award at grant date assuming that the highest level of performance conditions will be achieved if an amount less than the maximum was included in the table."

Risk Assessment Narrative Placement

This C&DI acknowledges that the new rules do not specify where the narrative disclosure of compensation policies and practices as they relate to a company's risk management should be presented. However, the SEC Staff recommends that this disclosure be presented together with the company's other Item 402 disclosure. The SEC Staff would have concerns if this disclosure is difficult to locate or is presented in a fashion that obscures it. [Question 128A.01]

Note: In a February 2010 speech, the SEC Staff indicated that if a company does not disclose any material adverse risks in its proxy statement, the SEC will, in the course of its review, issue a comment letter asking the company to explain the nature of the internal analysis that was conducted in making its determination that no disclosure was required. RiskMetrics Group also has weighed in on this issue. In a recently released FAQ,² RiskMetrics indicated that while it does not have a policy regarding nondisclosure of compensation risk assessment, companies should, at a minimum, talk about their process and any mitigating features (such as clawbacks or bonus banks). RiskMetrics views this disclosure "as an opportunity for communication, not simply compliance," and it expects "shareholders will be looking for a

² RiskMetrics' US Proxy Disclosure Requirements: FAQ, available at: http://www.riskmetrics.com/policy/2010_NewUSDisclosureFAQ

reasonably substantive discussion of the board's process to determine whether the company's incentive pay programs might motivate inappropriate risk-taking, and what they are doing to mitigate that."

Compensation Consultant Disclosures

Fee disclosure is not required if the *only* services provided by the consultant to the company relate to broad-based plans that do not discriminate in favor of executive officers and directors, **and**:

- The information *is not* customized for the particular company; **or**
- The information *is* customized based on parameters that are not developed by the compensation consultant.

If the consultant's role extends beyond these two types of services, then disclosure of *all of the consultant's services*, including consulting on broad-based plans and providing noncustomized information, will be required. If the noncustomized information relates to matters other than executive and director compensation, then the fees for such information would be for "additional services."

[Question 133.11]

Withdrawn C&DIs

In the March 1, 2010 update, the SEC withdrew the following C&DIs which dealt with issues concerning implementation of the new proxy disclosure rules prior to their February 28, 2010 effective date: Question 119.04, Question 119.05, Question 119.11, Question 119.12, Question 119.15, and Question 120.05.



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