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SEC Adopts Changes to Proxy and Form 10-K Disclosure Requirements

December 17, 2009

At an Open Meeting on Wednesday, December 16, 2009, the Securities and Exchange Commission (the "SEC" or the "Commission") voted 4-1 to adopt several new requirements relating to the disclosures public companies must make in their proxy statements and their Annual Reports on Form 10-K. The SEC's amendments relate to three general categories: corporate governance (directors and boards of directors); compensation matters; and compensation consultants. The SEC also adopted a new rule requiring that the results of shareholder votes be reported on a Current Report on Form 8-K within four business days of the meeting, rather than being disclosed in the periodic Report (on Form 10-Q or Form 10-K) that covers the period in which the vote was held. The rules and amendments adopted yesterday apply by their terms only to reports filed by domestic U.S. companies and therefore will not impose any new requirements on foreign private issuers. The final rulemaking release, SEC Release No. 33-9089 is available at http://www.sec.gov/rules/final/2009/33-9089.pdf (the "Adopting Release"). Page references in this memorandum are to the Adopting Release.

The rules are largely consistent with the proposals issued last summer, but there were several key changes which we discuss below. The rules are intended to apply to this upcoming proxy season. In light of this timing, companies should study the amended rules closely now to ensure compliance with the new requirements in annual reports and proxy statements filed this spring.

CORPORATE GOVERNANCE MATTERS

The Commission adopted two amendments to its corporate governance disclosure requirements which call for new and expanded disclosures about corporate boards and directors.

1. **An amendment to Items 401 and 407 of Regulation S-K to require several new and expanded disclosures about directors and director nominees.**

   This amendment will require that companies include in their proxy statements and Annual Reports on Form 10-K disclosures about:

   - **Qualifications**. The particular experience, qualifications, attributes or skills that led the company's board to conclude that a director or nominee should serve as a director of the company, in light of the registrant's business and structure. The staff at yesterday's Open Meeting confirmed this disclosure will be required for each director on an annual basis, even if that director is not up for election that year.

     Notably the SEC did not adopt those aspects of its proposals which would have required disclosure about directors' qualifications to serve on specific committees. However, the Adopting Release does note that "if an individual is chosen to be a director or a nominee to the board because of a particular qualification, attribute or experience related to service on a specific committee, such as the audit committee, then this should be disclosed under the new requirements as part of the individual's qualifications to serve on the board." (Page 35.)

     Similarly, although the Commission did not adopt the reference in the proposed rule to "risk assessment skills" because the Commission believes companies and other proponents should be afforded flexibility in determining what specific skills benefit the company, the SEC nevertheless has highlighted that if specific skill sets, "such as risk

> **"… accountability is impossible without transparency. By adopting these rules, we will improve the disclosure around risk, compensation, and corporate governance, thereby increasing accountability and directly benefiting investors."**
> —Chairman Mary L. Schapiro, Securities and Exchange Commission

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." (Page 35.)

- **Directorships**. Any public company directorships held by a director or nominee at any time during the past five years (the rules previously limited required disclosure only to concurrent directorships).

- **Legal Proceedings**. Any legal proceedings involving the director or nominee over the past ten years (the rules previously limited their scope to the past five years), including an expanded list of judicial or administrative proceedings that require disclosure. The rule now requires disclosure about judgments or orders finding a violation of: federal or state securities or commodities law or regulations; any law or regulation respecting financial institutions or insurance companies; or any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity; as well as sanctions or orders imposed by self-regulatory organizations, registered entities or equivalent exchanges and associations that have disciplinary authority over members and associated persons. An instruction to this new disclosure requirement makes clear that disclosure is not required of any settlement of a civil proceeding among private litigants.[1]

- **Diversity**. Information concerning diversity of the board and its directors. The new rules will require disclosure about:

  - Whether the board or nominating committee has a policy of considering diversity when evaluating director candidacies.

  - An assessment of how that policy has been implemented.

  - How the board or nominating committee assesses the effectiveness of its policy.

  The SEC noted that companies may define diversity "in various ways, reflecting different perspectives." (Page 39.) In light of this, the SEC has not defined diversity but has advised that for purposes of this disclosure, "companies should be allowed to define diversity in ways that they consider appropriate." (Page 39.) The SEC also expressly noted that diversity may signal not only racial or gender diversity but "some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity." (Page 39.)

In light of these new requirements, companies should focus on ensuring that they have all the information necessary to provide these disclosures, including appropriately updating their D&O questionnaires, or circulating supplemental D&O questionnaires. Presumably this highly personalized disclosure, including the newly required information about background and diversity, will be of particular interest to most directors. Accordingly, we encourage companies and their disclosure advisers to draft this disclosure early and provide their directors with an "advance" look at this disclosure with regard to any particular director.

2. Amendment to Item 407 of Regulation S-K and Schedule 14A to provide new disclosures about the board of directors.

The amendments adopted Wednesday will also require that companies provide enhanced disclosure about the leadership structure and risk oversight practices of their board of directors. More specifically, a company will need to disclose:

- Whether it combines or separates the positions of chief executive officer and chairman of the board, and why it believes that structure is the most appropriate structure for the company at the time of the filing. If the company has not separated the chief executive and chairman roles, the company will also need to disclose whether and why it has a lead independent director and the specific role played by that lead director in the leadership of the company.

- Information about the role of the board in the company's risk oversight and the effect, if any, this role has on the organization of the board leadership structure. This disclosure might also address whether and how the board, or board committee, monitors risk. Along these lines, the Commission explained in the Adopting Release that "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." (Page 44.)

[1] *See* Instruction 5 to paragraph (f) of Item 401 of Regulation S-K.

The SEC modified the final rule from the proposal in that the rule now speaks of “risk oversight” rather than “risk management”, clarifying some prior confusion. The Commission also noted, however, that it expects this disclosure “to provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company.” (Page 44.)

COMPENSATION MATTERS

The Commission also voted Wednesday to adopt two amendments to its rules governing compensation disclosure.

1. **Amendment to Item 402 of Regulation S-K to require new disclosures about general compensation policies and practices and the relationship of those policies and practices to the company’s risk profile, if material.**

   The rules adopted by the Commission Wednesday will require a company to assess whether its compensation policies and practices for employees, including non-executive officers, present risks that are “reasonably likely to have a material adverse effect” on the company. If a company determines that a compensation policy or practice, beyond those that relate only to executive officers, meets this threshold, then the company will need to provide disclosure pursuant to new Item 402(s) regarding that policy or practice and its effect on the company and its risk profile.

   The staff and the Commission have also emphasized that the standard of “reasonably likely to have a material adverse effect” was drawn from the well-known world of Management’s Discussion and Analysis (“MD&A”) and this disclosure approach should “parallel” the MD&A requirement which mandates “risk-oriented disclosure” of known trends and uncertainties that are material to the business. In this manner, the disclosure requirement has been significantly narrowed from the SEC’s proposal where compensation policies and practices would have triggered disclosure whenever risks arising from those compensation policies or practices “may have a material effect on the company”.

   Meredith Cross, the Director of the Division of Corporation Finance, also noted at yesterday’s Open Meeting that companies may consider offsetting or mitigating factors before concluding that a compensation practice or policy is reasonably likely to have a material adverse effect on the company. As the Adopting Release states, “if a company has compensation policies and practices for different groups that mitigate or balance incentives, these could be considered in deciding whether risks arising from the company’s compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company as a whole.” (Page 13.)

   Given the narrowed standard and this consideration of offsetting effects, we think many companies will not be required to make disclosure pursuant to this item. In this regard, it is also noteworthy that a company will not be required to include an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company. (Page 17.)

   Unlike the proposal’s original plan, this new disclosure will not be placed within a company’s Compensation Discussion & Analysis section (“CD&A”). Neither the staff nor the Adopting Release, however, have identified precisely where this new disclosure section should appear. Presumably it should be situated near the other required compensation disclosures, since this requirement is housed in Item 402 of Regulation S-K. It is also important to note that these amendments do not alter existing disclosure requirements regarding the relationship between the compensation of named executive officers and the company’s risk management policies when risk is a material aspect of the compensation of those executive officers. Although the latter is not an explicit component of the SEC’s executive compensation disclosure requirements, the Commission and its staff have recently highlighted that this disclosure is already mandated by the principles-based requirements of CD&A, when material.

   Consistent with CD&A, and also MD&A, the Commission has identified this new disclosure item as also being principles-based and has provided several illustrative examples to help in this area. For example, the Commission has suggested that, when assessing whether disclosure is required, companies should consider their 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.
   - At a business unit that is significantly more profitable than others within the company.

- At a business unit where 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.

Once a company has determined it needs to make disclosure in this area, new Item 402(s) of Regulation S-K also provides a principles-based list of matters a company may then want to consider including in its disclosure.

2. Revised disclosure of stock and option awards in the Summary Compensation Table and the Director Compensation Table to require inclusion of aggregate grant-date fair value, as computed under Statement of Financial Accounting Standards No. 123R ("FAS 123R")[2], of such awards.

The SEC has adopted an amendment that will require companies to reflect the aggregate grant-date fair value of stock and option awards in the Summary Compensation Table. This amendment effectively reverses the controversial action taken by the Commission in December 2006, which revised the rule at that time to require that companies disclose only the dollar amount recognized for financial reporting purposes under FAS 123R (generally, the amount determined by amortizing the grant-date fair value of awards over their vesting periods).

This change may affect the composition of the group of officers who are identified as the company's named executive officers (which will also affect the individuals subject to Section 162(m) of the Internal Revenue Code), so companies should pay close attention to this change and any impact it may have on the determination of its named executive officers for reporting purposes. For each executive officer included in this year's proxy, companies will be required to recompute the value of equity awards for any past fiscal years that are required to be included in the table. However, companies are not required to include different named executive officers for any past fiscal year based on recomputing total compensation for those years pursuant to the amendments.

The amendments adopted Wednesday include an instruction that, with regard to performance-based awards, the amount to be included in the Summary Compensation Table is to be calculated based on the probable outcome of the performance conditions at the time of grant. This instruction responds to concerns that this change might discourage the use of performance-based equity awards, or result in misleading and inflated disclosures in cases where such awards are made. The maximum possible award will, however, need to be disclosed in a footnote to the table.[3] Companies may also want to keep in mind the Commission's advice that in circumstances where a large "new hire" or "retention" grant "results in the omission from the Summary Compensation Table of another executive officer whose compensation otherwise would have been subject to reporting, the company can consider including compensation disclosure for that executive officer to supplement the required disclosures." (Page 22.)

There is discussion in the Adopting Release about the difference between awards granted during a year and awards granted after the end of the year for performance during such year. The SEC determined not to change the current rule that equity awards must be included in the Summary Compensation Table for the year of grant, even if the awards were for performance during the preceding year. Against this backdrop, however, the Commission reminds companies that they should "continue to analyze in CD&A their decision to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of named executive officers' compensation for the last fiscal year, and consider including supplemental tabular disclosure where it facilitates understanding the CD&A." (Pages 24-25.)

In another departure from the proposal, the Commission decided not to rescind the requirement to report the full grant-date fair value of each individual equity award in the Grants of Plan-Based Awards Table and corresponding footnote disclosure to the Director Compensation Table, concluding, based on comments received, that those disclosures reveal meaningful information about the value associated with each type of equity award granted and the mix of values among various awards with different incentive effects.

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[2] The final rule refers to Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation— Stock Compensation ("FASB ASC Topic 718"), which is the successor provision to FAS 123R.

[3] Instruction 3 to Item 402(c) of Regulation S-K.

COMPENSATION CONSULTANTS

The Commission also voted to amend Item 407 of Regulation S-K to require disclosure in the annual proxy statement of the fees paid to compensation consultants and their affiliates if those consultants (or affiliates) provide consulting services to the board of directors or the compensation committee related to executive or director compensation and also provide additional services to the company (such as those related to benefits administration, human resources consulting and actuarial services). Disclosure will also be required if the board or compensation committee does not have its own consultant, but a compensation consultant to the company also provides such additional services. In either case, the disclosure requirement is only triggered if the consultant receives fees in excess of $120,000 during the company's fiscal year for those other services. If the compensation committee (or the board) has its own consultant, and the company has another consultant which provides additional services, no disclosure will be required about those additional services or the fees paid for them.

Under those circumstances requiring disclosure, companies must provide the following information:

- The aggregate fees paid for all such additional services and the aggregate fees paid for work related to executive and director compensation consulting.

- Whether the decision to engage the consultant for services not related to executive compensation was made or recommended by management.

- Whether the board, or the company's compensation committee, approved the other services.

Disclosure will not be required if the consultant's only role in advising on executive compensation is with regard to broad-based plans that do not discriminate in favor of executive officers or when the consultant's services are limited to providing advice that is not customized to the company or is only customized based on parameters not developed by the consultant.

This amendment is intended to provide investors with meaningful disclosure that will assist them in understanding and assessing any conflicts of interest that are posed by compensation consultants providing services to a company in addition to advice and recommendations regarding executive or director compensation. The so-called "independence" of the compensation committee's consultants has received extensive attention from Congress in the past year and may well be the subject of upcoming legislation.

CURRENT REPORTING OF PROXY VOTING RESULTS

Finally, the Commission also voted Wednesday to adopt a rule that will require that companies disclose the results of shareholder votes within four business days after the end of the meeting at which the vote was held. This disclosure must be made pursuant to new Item 5.07 of Current Report on Form 8-K. Many commentators noted after this rule was proposed in July that it was not clear how a company should handle the situation where its shareholder votes are not certified within four business days of the meeting. In response to this concern, the SEC has provided Instruction 1 to Item 5.07 which explains that companies must file a Form 8-K announcing preliminary voting results within four business days of the shareholders meeting ending, and then file an amended Form 8-K within four days of the final voting results being known.

EFFECTIVE DATE

The new proxy disclosure rules will be effective as of February 28, 2010 (and with regard to the change in reporting of equity awards, will apply for years ended on or after December 20, 2009). The Commission and staff have not yet spoken as to whether early compliance will be permitted but we believe that most companies filing their annual reports on Form 10-K or their proxy statements (Schedule 14A) before that date will nevertheless want to comply fully with the new rules. Some type of guidance or exemption will be needed from the SEC, however, to allow companies to follow the revised rule for equity awards reporting (and therefore not provide the previously required data) in filings before the February 28, 2010 effective date.

NEXT STEPS FOR THE SEC

These new rules are an important step forward in advancing the SEC's agenda to increase corporate accountability through additional disclosure requirements. Chairman Mary Schapiro, however, has noted that "disclosure only takes us so far" and that there is a need to further empower shareholders through other tools and substantive changes to the corporate governance landscape. So-called "proxy access", or the ability of shareholders to put their own director nominees on the company proxy card, at company expense, is key among those tools for Chairman Schapiro (and others on the Commission). The Commission continues to consider an outstanding rule proposal on this topic, for which it recently extended the comment period until January 19, 2010 (the deadline originally expired on August 17, 2009). In the notice of its extension, the SEC highlighted four documents in its comment file that had originated after the original comment deadline and upon which the Commission is seeking additional public input. Despite the comment letter extension, Chairman Schapiro indicated Wednesday that she remains committed to having the Commission consider some form of proxy access early in 2010. Presumably such rules will not be effective until the 2011 proxy season at the earliest.

Proxy access and disclosures are not the only matters in this area receiving attention from Chairman Schapiro. She indicated in a speech on November 4, 2009, that she has directed the SEC staff to review "the entire process through which proxies are distributed and votes are tabulated" and that she anticipates that the Commission will be issuing a Concept Release in the near term to solicit public comments on matters in this area (including empty voting, over-voting, shareholder communications, NOBO/OBO, and proxy advisory firms, among others). She reiterated Wednesday her commitment to this comprehensive review of the "infrastructure that supports the proxy process — from ensuring the integrity of voting results to reviewing the role of proxy advisors."

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.

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