



Hot Topics

Considerations for Navigating the SEC's New Proxy Disclosure Rules

To help companies navigate the SEC's new [proxy disclosure enhancement rules](#), this edition of *Hot Topics* summarizes the new primary disclosure areas. It also provides information to consider in drafting the disclosures and additional resources that may be helpful.

Compensation policies and practices

The new SEC disclosure requirement regarding compensation-policy risk gives companies the opportunity to take a fresh look at their compensation programs, especially the incentive plans. While risk has always been an implicit consideration in the design of incentive compensation programs, the new requirement provides management and the compensation committee with an opportunity to have a constructive discussion regarding the level of risk taking that should be allowed in the company's incentive plans. It also allows an excellent opportunity to improve the design of incentive plans and the required internal controls.

The new SEC rules require certain disclosures by companies that conclude that their compensation policies or practices are reasonably likely to create material adverse risk. To determine if the disclosure requirement applies, all companies should conduct a risk assessment that:

- Inventories all the company's incentive plans
- Evaluates whether the plans are likely to motivate behavior that could be detrimental to the company
- Considers the countermeasures in place to prevent risk taking, such as internal controls and compensation design features.

The final SEC rules make clear that countermeasures can be considered in evaluating whether the risk created by the company's compensation policies is material. Common countermeasures include clawbacks, multiple performance metrics, incentive payment caps, use of corporatewide financial measures, stock ownership guidelines, a balanced emphasis on short- and long-term results, and rigorous "stress testing" of performance metrics prior to adopting the incentive plan. Most companies employ multiple countermeasures, which will significantly influence the risk evaluation.

Companies that conclude that one or more of their incentive plans or compensation policies are reasonably likely to create material adverse risk are required to disclose the following in a new section of the proxy:

- The compensation philosophy for employees affected by these plans or policies
- How the company factored such risk taking into the design of the plans or policies
- Any mitigation strategies, such as holdbacks or deferrals, that have been incorporated into the plans
- Any material adjustments to the company's compensation policies that have been made to address changes in the company's risk profile
- The extent the company monitors its compensation policies and practices to ensure they remain within the risk management objectives of the company.

The SEC will not accept boilerplate language or generic statements about needing incentive plans to attract and retain employees. The rationale for maintaining high-risk plans must be clearly detailed.

For additional information on executive compensation, visit the Center for Corporate Governance Web site's [Executive Compensation page](#).

Considerations

- Has the company considered and documented its appetite for compensation risk?
- Does the company have appropriate countermeasures to minimize excessive risk taking? What are they?
- In addition to incentive plans, do other compensation policies encourage aggressive risk taking, such as generous severance benefits?
- Are there any changes that the company should make to the compensation policies or programs to further reduce risk?
- Have the risk-review process and findings been documented in the event that the SEC asks the company the basis for not disclosing compensation risk?
- Should the company voluntarily disclose the risk-review process and results even though management concluded the plans are not likely to create material adverse risk?
- Has the compensation committee worked with the audit or other committees in aligning the compensation plans with the risk assessed?

Executive and director compensation tables

The SEC has changed the reporting of equity-compensation awards back to its original 2006 proposal requiring that companies report the full amount of equity awards granted during the year. Previously, companies were required to disclose the amount recognized as an expense for financial reporting purposes. Performance-vested stock options and shares are to be reported in the summary compensation table based on their probable performance outcome as determined at the grant date value. A footnote in the table must disclose the maximum value that can be earned. In addition, to allow comparability, all prior years are to be restated using the new standard.

Importantly, the SEC release recognizes that the use of awards granted during the year may cause newly hired or promoted executives to be considered among the three most highly compensated executives required to be reported in the proxy, in addition to the chief executive officer and the chief financial officer. In such cases, the SEC allows companies to include other executives, in addition to the newly hired or promoted executives, to provide a more accurate picture of the named executive officers.

Considerations

- Companies will want to consider how their long-term incentive granting practices influence who is considered a named executive officer.
- In addition to reporting implications, such disclosure affects who is subject to Section 162(m) of the Internal Revenue Code and some of the compensation limitations under the Troubled Asset Relief Program, as amended by the American Recovery and Reinvestment Act.
- The change in equity reporting affects the determination of total compensation in the proxy's summary compensation table. That, in turn, determines who has to be reported in the proxy; some executives who get a sign-on equity award, for example, may be among the named executive officers under the new rules.

Director qualifications

The new rules expand on the required information provided about the background and experience of directors and nominees. The rule notes that the disclosure should include information about the experience, qualifications, and attributes considered in the nomination and reasons why the individual should serve on the company's board. Disclosure is also required regarding legal proceedings the director has been involved in for the previous 10 years and all board memberships for the past five years.

Considerations

- The general counsel/corporate secretary and the board (nominating/governance committee) should have copies of or have seen the current biographies of all board members.
- Consider the unique skills and experiences of each board member included in his or her biography and, perhaps, disclose the relevant areas that may distinguish him or her.
- Consider discussing the board's policy and process for recruiting and nominating board members.
- Does the board use a matrix to map current skills, experience, and other qualities?
- Does the matrix help identify where there may be gaps on the board? What process is followed to address such gaps? Before finalizing, consider providing the disclosure regarding a director's qualifications to the candidate for review.
- Companies should consider revising their director and officer questionnaire to collect requested information about past directorships and legal proceedings. This may require companies to expand the legal proceedings to cover the past 10 years, rather than five years, and to include all directorships for five years, as opposed to current board memberships.
- If the disclosure about a certain director includes unique qualifications, consider how the board would fill that membership if the board member departs.

For additional information, visit the Center for Corporate Governance Website's [Board Composition and Recruitment](#) page.

Board leadership structure

With the debate over whether U.S. companies should split the role of the chief executive officer and chairman, the SEC's new rules require disclosure of a company's leadership structure and why it has chosen to either combine or separate the positions. The disclosure must include an explanation of why the company believes its current structure is appropriate. If the two positions are combined, the company must disclose whether it has designated a lead independent director and, if so, an overview of that individual's role.

Considerations

- Has the board discussed its leadership structure? What are its views on the current structure?
- Be aware of the pros and cons of each structure and consider including information in the disclosure to respond to such points. The benefits of splitting may include eliminating conflicts of interests. The disadvantages may include a potential confusion over who is leading the company.
- If the company has a combined structure, consider disclosing information about the individual and his or her skills for filling both positions.
- If the chief executive officer and chairman positions are split, consider providing information about each individual and why he or she is qualified for that position.
- With regard to the role of lead director, does the company have a job description to help define the role and distinguish it from the chief executive officer and chairman roles?

The following resources on the Center for Corporate Governance Website's [Roles and Responsibilities](#) page provide additional information on this topic:

- *Independent, Nonexecutive Chairman of the Board — The Debate Continues* (Deloitte Hot Topics article, September 2009)
- *Chairing the Board: The Case for Independent Leadership in Corporate North America* (Yale School of Management's Millstein Center for Corporate Governance and Performance, March 2009)
- *The Nonexecutive Chairman: Offering New Solutions* (Spencer Stuart, January 2008).

Board diversity

The new rules state that a company must disclose “whether, and if so, how, a nominating committee (or the board) considers diversity in connection with identifying and evaluating persons for consideration as nominees for a position on the board of directors.” Disclosure should note if a policy exists to guide the board’s consideration of diversity in identifying director candidates and, if so, how such policy is implemented and measured for effectiveness.

The following resources on the Center for Corporate Governance Web site’s [Board Composition and Recruitment](#) page provide additional information on this topic:

- *Different is Better — Why Diversity Matters in the Boardroom* (Russell Reynolds Associates, March 2009)
- *A New Breed of Director Emerges as Public Policy Enters the Boardroom* (Korn Ferry, February 2009)
- *Women and Minorities on Fortune 100 Boards* (Catalyst, The Prout Group, The Executive Leadership Council, and the Hispanic Association on Corporate Responsibility, December 2008).

Considerations

- Has the board defined diversity and, if so, how?
- Does the definition focus on gender, race, and ethnicity, or skills, experiences, and other qualities, or both?
- How is the definition considered in the context of board composition and recruiting?
- Does the board or nominating committee use a skills matrix? If so, how is diversity considered in the matrix? Is it aligned with how the board has defined diversity?
- How does the board’s composition compare to the makeup of the company’s employee base?
- Does the company or board maintain a diversity policy? How is it implemented and how is its effectiveness measured?
- Does the company have a chief diversity officer? If so, how is he or she involved in the director nomination process?

Compensation consultants

The SEC’s final rules require disclosure of fees paid to compensation consultants and their affiliates in certain circumstances. If a compensation consultant and its affiliates provide services in addition to consulting on executive or director compensation, the company must disclose the fees if in excess of \$120,000. There is no requirement to disclose the type or nature of the unrelated services and disclosure is not required for consulting on broad-based, non-discriminatory compensation plans. The company must also disclose if the board approved such other services.

This rule is intended to provide investors with information to help them better assess the potential conflicts of interest that compensation consultants might have in recommending executive compensation. The final rules are consistent with the original proposal, except the disclosure requirement does not apply to consultants retained by management if the compensation committee has its own consultant.

Considerations

- If the company uses the executive compensation consultant’s firm for other services, should the types of services be disclosed to shareholders?
- Why does the company believe the executive compensation consultant is objective and provides unbiased advice?

For additional information, visit the Center for Corporate Governance Web site’s [Compensation Committee](#) page.

Board risk oversight

The new rules require disclosure about the board's role in risk oversight and suggest that companies may want to discuss whether the full board or board committees should be involved in the oversight. Companies may want to disclose whether the employees responsible for risk management report to the board.

Considerations

- Has the board discussed risk oversight? How involved is the full board in the risk discussions? Has the company or board defined the board's role in overseeing risk?
- Is the board responsible for advising on or discussing the risk appetite of the organization?
- Does the board work with management to discuss and evaluate risks in determining and executing the company's strategy?
- What is the risk governance structure? Who owns risk oversight? Do certain committees oversee certain risks? Which committee oversees the enterprise risk management policies and procedures that have been established by management?
- If certain committees are involved, do these committee charters include such responsibility?
- Does the company have a chief risk officer? If not, who is ultimately responsible for the enterprise risk management process and does that person report to the full board or a board committee?
- Does the board have a thorough understanding of how risks are identified from all levels of the organization and how such risks reach the board for discussion?
- How often is risk on the agenda for the full board or board committees?
- Consider the board's role in risk oversight in the context of the following areas:
 - Defining the board's role in risk oversight — what is the risk governance structure?
 - Setting the tone of a risk-intelligent culture
 - Helping management incorporate risk thinking into the company's strategy
 - Advising on risk appetite
 - Executing an effective governance process to oversee risk management
 - Benchmarking and evaluating the governance process.

The following resources on the Center for Corporate Governance Web site's [Risk Oversight](#) page provide additional information on this topic:

- *Risk Intelligent Governance: A Practical Guide for Boards* (Deloitte, August 2009)
- *What Might Companies Do about the Risk Elephant in the Room?* (Deloitte, *Hot Topics* article, October 2009)
- *Risk Intelligence in a Downturn: Balancing Risk and Reward in Volatile Times* (Deloitte, April 2009).

For more information on the new disclosure rules, please see our special edition [January 2010 Hot Topics article](#).