

AN ALERT FROM THE BDO COMPENSATION &amp; BENEFITS TAX PRACTICE

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## COMPENSATION & BENEFITS



### ► SUBJECT

## SEC ISSUES FINAL REGULATIONS ON COMPENSATION DISCLOSURE FOR THE 2010 PROXY SEASON

### ► OVERVIEW

On December 16, 2009, the Securities and Exchange Commission ("SEC") issued final regulations related to annual disclosure of executive compensation matters and corporate governance. These regulations, which are effective for proxy statements and annual reports filed after February 28, 2010, contain some significant changes from the proposals in this area that the SEC issued in July 2009. The final regulations focused on several areas, and this Tax Alert will briefly summarize the provisions of the regulations concerning executive pay and the impact on corporate filers.

### ► MANAGEMENT OF COMPENSATION RISK (AND OTHER RISKS)

One of the themes that government officials and investors have cited as a primary reason for the current economic crisis is that compensation programs caused corporate executives to take unnecessary risks to obtain their bonuses, and boards of directors were not monitoring that risk. As a result of this perception, the SEC is now requiring a special section in the proxy filing that discusses the risks that the compensation programs may cause to the enterprise.

Specifically, the SEC requires the employer to address any risks arising from its compensation policies and practices, for *all employees*, if those policies and practices are *reasonably likely* to have a *material adverse effect* on the employer. This final rule reflects certain changes from the proposed regulation, including the following:

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- All compensation programs for all employees need to be reviewed to determine if they may cause a material adverse effect on the employer. The proposed regulations did not require a review of all programs.
- Employers will need to define the term “reasonably likely”, so that they can judge whether disclosure needs to be made. The SEC, in its commentary, indicated that the use of “reasonably likely” is to be considered as similar to the “reasonably likely” disclosure standards that corporations use in the Management Discussion and Analysis section of their annual report (Form 10-K).
- Employers will also need to determine what constitutes a “material adverse effect” to the enterprise. The SEC indicated that the “material adverse effect” standard, which differs from the “material effect” standard set forth in the proposed regulations, is designed to reduce the types of compensation programs that must be disclosed, as corporations would not have to disclose what offsetting arrangements existed to mitigate certain programs.
- The SEC identified certain situations that could trigger disclosure, including:
  - Programs at a business unit that carry a significant portion of the employer’s risk profile;
  - Programs at a business unit that has a significantly different method of paying its employees than the rest of the enterprise;
  - Business units where compensation expense is a significant percentage of revenue; and
  - Programs that pay upon accomplishment of a task, while the income and risk to the employer extend over a significantly longer time period.
- The SEC also identified certain items that should be discussed if a program is deemed reasonably likely to have a material adverse effect on the employer, including:
  - What components of the employer’s general compensation program/practices design philosophy relate to risk taking?
  - What methodology is used to assess risk and incentive programs?
  - Are any features, such as clawbacks or holding periods, used to offset the risk based on long term results of the programs?
  - If the employer’s risk profile changes, how do the compensation programs/policies adjust? Also, have any adjustments been made in the past?
  - Is the employer managing and monitoring compensation policies/practices to determine if risk management objectives are being met?

The emphasis on compensation risk poses a number of challenges for companies that must report on this issue in their next SEC annual or proxy filing; this is the one issue contained in the final regulations that poses the greatest difficulty for compliance in this initial year of the final regulations. We believe that, in order to make an accurate and meaningful disclosure, employers must perform a careful analysis, which would include such topics as the identification of risks to the enterprise, definition of materiality, review of programs for potential issues, and creation of a monitoring system. If done correctly, this is not a small task.

Additionally, the filing will now need to describe the board of directors’ role in the oversight of corporate risk. This disclosure is not limited to the potential risk caused to the enterprise by compensation programs, but is to discuss any other types of risk; as examples, the SEC identified credit risk, liquidity risk, and operational risk as three other types of risk that an enterprise faces. Many boards will need to face the issue of what committee will take responsibility for oversight of corporate risk (or whether that should be the responsibility of the board as a whole). To fulfill these requirements, some firms may create a new risk oversight committee.

## ► CHANGES TO THE SUMMARY COMPENSATION TABLE (“SCT”)

The final regulations provide a new methodology for reporting the value of equity grants. The SEC is directing employers to report the aggregate grant date fair value of equity awards on the SCT. Prior practice was to report the amount of the financial statement expense related to grants to named executive officers (“NEOs”) and directors. The new practice is believed by many to provide a more accurate view of the reward that an NEO received for work performed in the year relating to the filing.

Companies that award performance-based equity will need to make an estimate of the likelihood of satisfaction of the performance condition, and note the entire value of the grant in a footnote.

For comparison purposes, the grants to all of the current year NEOs/directors who were NEOs/directors in prior years will need to be restated; however, the identities of NEOs will not change as a result of the restatement.

We do not believe that this will be a difficult change for filers to implement.

## ▶ ENHANCED DISCLOSURE OF DIRECTOR QUALIFICATIONS

The final regulations direct a filer to provide additional disclosure about the qualifications and other board positions held by its directors and nominees to the board. Among the items needed to be disclosed, on an annual basis, are:

- The particular experience, qualifications, attributes and/or skills that led the board to conclude that the individual would be a good director for the company.
- Any particular qualifications that make an individual a good candidate to serve on a specific committee.
- All directorships at public companies and regulated investment companies for the past five years.
- Any legal proceedings involving directors, nominees, and executive officers within the last ten (10) years -the prior rule was five years - and additional disclosure of *administrative* proceedings involving mail and wire fraud, violations of federal or state securities, commodities, banking, or insurance laws and any disciplinary sanctions imposed by a stock, commodities, or derivatives exchange.

Additionally, the SEC requires a disclosure as to how the board considers and addresses diversity among board members and whether a diversity policy for board members exists, is implemented, and is monitored. The SEC did not define the term “diversity.”

## ▶ CORPORATE STRUCTURE

The final regulations require a company to disclose whether and why it keeps the title and responsibilities of the chairman of the board and the chief executive officer in the hands of one person or two. If a company combines the positions in one person, and has a director designated as the “lead independent director,” the duties of the lead independent director need to be discussed along with the company’s justification for allowing one person to serve as both chairman and chief executive officer.

## ▶ FEES PAID TO COMPENSATION CONSULTANTS

In response to a perception in the marketplace that compensation consultants who perform other services for a corporation may not be sufficiently independent, the SEC has created the following rules for disclosure of fees paid to the consultants.

1. If the board hires its own consultant and the consultant does no other work for the company, no fee disclosure is necessary - either for fees paid to the board’s consultant or to any other compensation consultants used by the company.
2. If the board hires its own consultant and the consultant performs non-executive compensation services for the company in excess of \$120,000 per year, fee disclosure is necessary - both for the other work and the work done for the board.
3. If the company hires a consultant and the consultant does work for the board and performs non-executive compensation services for the company in excess of \$120,000 per year, fee disclosure is necessary - both for the other work and the work done for the board.
4. Services performed by the consultant that are not related to executive compensation (for example, services involving broad-based compensation programs or certain types of surveys), do not require fee disclosure.

## ▶ WHAT EMPLOYERS SHOULD BE DOING NOW

We believe that the most significant issue involves the analysis of compensation related risk; among the changes contained in the final regulation, this is the area that will require the most additional work. To conduct this analysis, in its simplest terms, employers need to inventory all of their compensation programs and examine them in light of the risks that they pose to the enterprise. However, beyond conducting an inventory, employers should be considering the following as part of the assessment:

1. Who should be conducting the assessment - human resource employees, in house counsel, risk function personnel, the consultants who assisted in the creation of the programs, outside counsel and/or independent consultants?
2. What role should the board play-setting standards, working on the preparation of the report, solely as reviewers?
3. How does the enterprise define the terms "risk," "materiality," and "reasonably likely"?
4. How does this analysis fit in with the other risk management functions of the board?
5. As this analysis will be ongoing, how can it be structured so future analyses will be easier?

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