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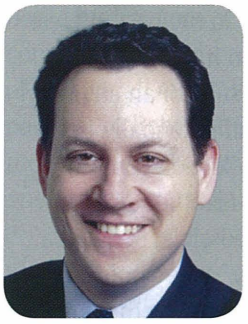
The SEC's Expanded Governance and Executive Compensation Disclosure Requirements

By David C. Karp & Jeremy L. Goldstein

New rules for the 2010 proxy season take effect on February 28.



David C. Karp

Jeremy L. Goldstein

Late last year, the SEC adopted final rules that broaden the scope of required corporate governance and executive compensation disclosures in public company proxy statements. These enhanced proxy disclosure items reflect a heightened political and regulatory focus on corporate practices that some have linked to the economic turmoil of recent years.

Boards will need to address these new disclosure requirements promptly, as they become effective on February 28, 2010, in time for the 2010 proxy season. Preparation will largely involve expanding the information collected by those responsible for drafting the company's proxy statement and board discussion concerning the presentation of this information in compliance with the new requirements.

Enhanced Corporate Governance Disclosures

In response to a perceived failure of risk management at some financial firms, the rules require a proxy statement description of board supervision of the corporate risk function. Importantly, the rules recognize that company executives are responsible for day-to-day risk management and instead focus only on the board's oversight role. Audit committees of NYSE-listed companies have for some time been required to discuss policies with respect to risk oversight, and accordingly these discussions will in many cases be the focal point for developing disclosures in response to the new mandate.

The new rules also expand required disclosures about directors and director nominees, mandating an annual discussion of the specific experiences and skills relevant to service as a director. In addition, the rules impose longer look-back periods for disclosure of other directorships (5 years) and of legal proceedings (10 years), with an expansion of the types of disclosable legal proceedings. Directors will need to thoughtfully respond to longer D&O questionnaires being developed by companies to elicit information necessary to comply with the new requirements.

Over the past decade some companies have separated the Chairman and CEO positions while other companies have named a lead director. Companies will now be required to describe, and justify, in their proxy statements their leadership structure, including whether and why a company has chosen to combine or separate the CEO and Chairman positions, and whether and why a company has a lead independent director. Compliance with this requirement should not be difficult, but companies should be sensitive to writing their disclosures in a manner that does not reduce their flexibility to adopt alternative leadership structures as personnel and other changes occur over time.

The new rules require companies to disclose in their proxy statements whether, and if so, how, the board's nominating committee considers diversity in board composition. If the nominating committee has a policy regarding board diversity, the company must describe how the nominating committee implements, and assesses the effectiveness of, the policy. For purposes of this disclosure, each company may define diversity as it deems appropriate, and may consider any number of factors, such as professional experience, education, race, gender or national origin.

Enhanced Executive Compensation Disclosures

The rules require valuation of equity awards in the Summary Compensation Table and Director Compensation Table based on the grant date fair value of awards made during the covered year, rather than the accounting expense recognized during the covered year for all outstanding awards. For performance awards, grant date fair value will be based on the probable outcome of the performance conditions, with footnote disclosure regarding award value in the event of "maximum performance." Under the rules, companies must re-calculate amounts (including amounts reflected in the total compensation column) for

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each preceding fiscal year required in the table, but do not have to change the individuals who constitute named executive officers as a result of the recalculations.

To the extent that risks arising from a company's compensation programs for employees generally (not just executives) are reasonably likely to have a material adverse effect on the company, the rules require a stand-alone proxy statement disclosure, independent from the Compensation Discussion & Analysis, of the company's compensation programs as they relate to risk management and risk-taking incentives. Directors should, through their risk oversight role, satisfy themselves that management has designed and implemented processes to analyze risks arising from a company's compensation programs, and should receive reports related to the identification and mitigation of risks in the company's compensation programs prior to the inclusion of the risk-related disclosure in the company's annual proxy statement.

Finally, in response to the perception that there may be a conflict of interest when compensation consultants work on projects both for the corporation and its board, the new rules require disclosure of fees paid to compensation consultants and their affiliates if a consultant that is providing executive or director compensation consulting services or any of its affiliates also generally provides other services over $120,000. If the board and management each have their own consultant, disclosure is not necessary for consultants working with management even if the consultant hired by management provides other services. Boards will need to satisfy themselves that their companies implement appropriate disclosure controls to track consulting fees and to determine whether disclosure is required.

Looking Ahead

Directors will also need to stay abreast of further regulatory developments, as these new disclosure requirements are merely a "down payment" on further changes in the proxy area. The SEC has not yet taken final action with respect to proposed rules regarding the proxy solicitation process, though it remains highly likely that the SEC soon will adopt some form of its proposal to require companies to include directors nominated by shareholders in company proxy statements and proxy cards.

David C. Karp is a corporate partner at Wachtell, Lipton, Rosen & Katz. His practice concentrates on mergers and acquisitions, corporate governance and corporate and securities law matters. He was named a "Dealmaker of the Year" by The American Lawyer in 2006 for his work advising the New York Stock Exchange in its acquisition of Archipelago Holdings and the NYSE's subsequent initial public offering. In 2008, the International Financial Law Review recognized the cross-border merger of the NYSE Group and Euronext, in which Mr. Karp advised the NYSE Group, as the "M&A Deal of the Year." Mr. Karp served as counsel to the New York Stock Exchange Corporate Accountability and Listing Standards Committee. Mr. Karp earned a J.D., with honors, from the University of Chicago Law School in 1993, where he was a member of the University of Chicago Law Review, and an A.B., magna cum laude, from Harvard in 1990.

Jeremy L. Goldstein is a partner at Wachtell, Lipton, Rosen & Katz. He is active in the firm's executive compensation and corporate governance practices, and has been involved in many of the largest corporate transactions of the past decade. Mr. Goldstein has a J.D. from New York University School of Law, an M.A. from the University of Chicago and a B.A. cum laude and with Distinction in All Subjects from Cornell University. He also is a member of the Professional Advisory Board of the NYU Journal of Law and Business. He is a member of the New Leadership Council of Make-A-Wish Foundation® of Metro New York. In addition, Mr. Goldstein writes and speaks frequently on corporate governance and executive compensation issues and is listed as a leading executive compensation lawyer in The Legal 500.

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and executive pensions, should be minimized as much as possible.

Eliminating these shareholder irritants will allow the board to focus on paying for performance, setting challenging goals based upon history and analyst expectations, and increasing stock ownership.

The challenges facing corporations and their boards are significant. If we separate myths from realities, shareholders, the executives and board members will all benefit.

Ira T. Kay is the managing partner of Ira T. Kay & Company, LLC, a leading independent and objective advisor on executive compensation to boards and management. One of the nation's foremost experts on executive compensation, Ira served as the global director of Watson Wyatt's (now Towers Watson) Executive Compensation practice for 16 years. He is a noted author of several books, a frequently quoted source for major U.S. media, and his research focuses on the relationship between executive pay and company performance. A long-time analyst of the executive pay model, Mr. Kay writes and speaks regularly on executive compensation issues. His most recent book, (co-authored with Steven Van Putten), *Myths and Realities of Executive Compensation*, (Cambridge University Press) documents the realities of executive pay in the United States and the forces that have shaped pay in recent years. He is also the author of *The Human Capital Edge* (McGraw-Hill), *CEO Pay and Shareholder Value: Helping the U.S. Win the Global Economic War*, (St. Lucie Press), and *Value at the Top: Solutions to the Executive Compensation Crisis*, (Harper Collins). He holds a B.S. in Industrial and Labor Relations from Cornell University and a Ph.D. in economics from Wayne State University.