

SEC FLASH REPORT

SEC Approves Enhanced Disclosure about Risk, Corporate Governance and Compensation

December 17, 2009

Yesterday, the Securities and Exchange Commission (SEC) approved rules to enhance the information provided to shareholders so they are better able to evaluate the leadership of public companies. Beginning in the upcoming annual reporting and proxy season, the new rules will improve corporate disclosure regarding risk, compensation and corporate governance matters when voting decisions are made.

According to the SEC's press release at <http://www.sec.gov/news/press/2009/2009-268.htm>, the new rules require enhanced disclosures in proxy and information statements about:

<i>RISK</i>	<ul style="list-style-type: none">• The board's role in risk oversight• To the extent to which risks arising from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company, information about such policies and practices as they relate to risk management
<i>CORPORATE GOVERNANCE</i>	<ul style="list-style-type: none">• The background and qualifications of directors and nominees• Board leadership structure• The consideration of diversity in the process by which candidates for director are considered for nomination• Quicker reporting of shareholder voting results• Legal actions involving a company's executive officers, directors and nominees
<i>COMPENSATION</i>	<ul style="list-style-type: none">• Stock and option awards to company executives and directors• Potential conflicts of interests of compensation consultants

Effective Feb. 28, 2010, the new rules focus on corporate accountability and the need of investors for additional information that would enhance their ability to make informed voting and investment decisions. Generally, the effective date means the new disclosures begin in the upcoming annual reporting and proxy season for calendar year reporting companies. However, it is not clear whether a proxy statement filed prior to February 28, 2010 in conjunction with an annual shareholders meeting scheduled after February 28 must comply

with these rules. If further guidance is not provided, companies facing this situation should inquire of the SEC staff as to the Commission's intent.

The Commission received over 130 comment letters in response to the proposed amendments. In general, the letters supported the objectives of the proposing release with most commenters supporting the manner in which the SEC proposed to achieve these objectives. While there was some opposition and suggested modifications to the proposals, a substantial majority of the commenters supported additional disclosure from companies.

The final rules are available at <http://www.sec.gov/rules/final.shtml>.

Each of the aforementioned areas affected by these new rules is discussed further below.

Information on the Board's Risk Oversight Role

The new rules require disclosure about the nature and extent of the board's risk oversight. The Commission's final rules expressed the rationale for this additional disclosure as follows:

Companies face a variety of risks, including credit risk, liquidity risk, and operational risk. ...[D]isclosure about the board's oversight of the risk management process should 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. This disclosure requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. 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.

The SEC's disclosure objective is to address questions as to whether the persons responsible for risk management report directly either to the full board or to a designated board committee, and whether and how the board or board committee monitors risk.

Protiviti Commentary: In finalizing its rules, the SEC reported that it was persuaded by commenters who pointed out that "risk oversight is a key competence of the board and that additional disclosures would improve investor and shareholder understanding of the role of the board in the organization's risk management practices." The Commission's objective is to provide greater transparency into how the board operates to provide oversight with respect to the company's risk management.

The proposing release used the term, "risk management," in requiring disclosure of the board's involvement. As we predicted in our July 16, 2009 Flash Report on the proposing release, some commenters were troubled by this language because, in general, boards do not manage risk. Rather, risk management is a management function and boards provide oversight of that function. Now that the SEC is more appropriately using the term, "risk oversight," the final release recognizes the important distinction between the board's role and management's role insofar as the issuer's risk management process is concerned.

Because risk oversight is a high priority for today's boards of directors and the risk oversight playbook is likely to evolve over time, Protiviti has initiated a new series, *Board Perspectives: Risk Oversight*, to assist directors as they evaluate and refine their board's risk oversight process into 2010 and beyond. This series is available at www.protiviti.com.

How Compensation Policies and Practices Relate to Risk Management

The SEC's new rule, among other things, would require a narrative disclosure about the company's compensation policies and practices for all employees, not just executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. The objective of this rule is to help investors determine whether a company has created incentives for employees to undertake excessive or inappropriate risks that can affect the company's risk profile and its management of risk. The rule will not be a part of the Compensation Disclosure and Analysis (CD&A), as originally proposed, but will be incorporated into Item 402 of Regulation S-K.

To illustrate its intentions, the SEC provides a non-exclusive list of situations where compensation policies may have the potential to create material risks to companies. These situations could trigger discussion and analysis of compensation policies and practices:

- A business unit which carries a significant portion of the company's risk profile
- A business unit with compensation structured differently than other units within the company
- A business unit that is significantly more profitable than other units within the company
- A business unit where compensation expense is a significant percentage of the unit's revenues
- Situations 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 that completed task extend over a significantly longer period of time

In listing the above situations, the SEC makes it clear that the list it provides is not intended to be all inclusive and is intended only to provide illustrative examples of situations where compensation programs may have the potential to create material risks to the company. The objective is to disclose compensation programs which may have the potential to create risks which may have a material adverse effect on the company. For example, if a particular business unit carries a disproportionate share of the company's overall risk and is significantly more profitable than other units within the organization, then the compensation policies related to the key employees of that unit could be as essential to understanding the overall financial condition and performance of the company as the policies affecting executive management. Similarly, if a business unit has its compensation structured differently than other units within the company, or has an overall risk and reward structure that varies significantly from the rest of the company, then disclosure might be warranted if the effects of the compensation policies could have a material adverse effect on the company.

To further clarify its intent, the SEC also provides several examples of issues that companies would need to address regarding the compensation policies or practices in effect if they might give rise to risks that could have a material adverse effect on the company. These examples include the following:

- The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by those policies and practices, as such policies and practices relate to or affect risk taking by those employees on behalf of the company, and the manner in which they are implemented.

- The company's risk assessment or incentive considerations, if any, in structuring its compensation policies or in awarding and paying compensation.
- How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods.
- The company's policies regarding adjustments to its compensation policies and procedures to address changes in its risk profile.
- Material adjustments the company has made to its compensation policies or practices as a result of changes in its risk profile.
- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to providing the appropriate incentives to its employees.

Rather than generic or boilerplate language, the Commission states that it was looking for companies to assess its compensation structure in light of the current situation. Therefore, the level of detail required will necessarily depend on the particular facts and circumstances at a given company and within its various business units.

Smaller reporting companies will not be required to provide the new disclosure, which in effect mirrors their not being required to provide CD&A disclosure.

Protiviti Commentary: These expanded disclosures will require careful thought – particularly in industries with significant financial, commodity, research and development, project, and product/service failure risks – around how to articulate to the public issues management and directors may not have discussed in an open, robust manner in the past. While the objective of these expanded disclosures is understandable in view of the ongoing debate over some of the root causes of the recent financial crisis, the specifics around when and how to make these types of disclosures will not be crystal clear to every company in every circumstance. Several commenters pointed to the absence of clearly defined standards by which the relationship between compensation and risk is to be evaluated. Still others argued that these disclosures need to be placed in the context of a company's business, operations and competitive environment.

To that end, the SEC modified its disclosure threshold in two important ways to sharpen the focus on the disclosures the Commission is looking for:

- First, the proposing release language of “may have a material effect on the company” was modified to “reasonably likely to have a material adverse effect on the company.” The change of “may have to “reasonably likely to have” aligns the disclosure threshold with the threshold used in the Commission’s Management Discussion and Analysis (MD&A) rules and, in the view of the SEC, is intended to elicit disclosure about incentives in the company’s compensation policies and practices that would be most relevant to investors. According to the SEC, this change from the proposing release also addresses concerns raised by some commenters that the proposal did not allow companies to consider compensating of offsetting steps or controls designed to limit risks of certain compensation arrangements.
- Second, the change from “a material effect” to “a material adverse effect” raises the disclosure threshold even higher. Well-designed compensation policies can enhance a company’s business interests by encouraging innovation and appropriate levels of risk-taking. By focusing on material adverse effects, the final rule is intended to avoid voluminous boiler plate discussion of compensation arrangements.

The enhanced disclosures basically force management and the board to ask the rhetorical question, “Is there anyone within our organization who can ‘bet the house’ without our knowledge?” The disclosures should address whether the issuer's overall compensation and incentive structure reward short-term risk taking without regard to the potential long-term effects on the company. They will likely drive an ongoing analytical and forward looking approach to assessing risk that not only takes into account changes in the operating environment over time but also considers the potential cultural implications of compensation practices on corporate behavior.

The movement of the expanded disclosures from the CD&A (as required by the proposing release) to Regulation S-K was done to avoid the confusion which might arise from expanding the CD&A beyond the company’s executive officers to also include disclosure of the company’s broader compensation policies and practices for employees.

In the proposing release, the SEC asked for comment as to whether it should require an affirmative statement that the issuer has determined that the risks arising from its compensation policies are not reasonable expected to have a material effect, if the issuer concludes that disclosure is not required. Commenters’ reactions were mixed on this proposal, with some pointing out that the Commission has not traditionally required companies to address affirmatively matters that they determine are not applicable to it. Accordingly, the SEC decided not to require the affirmative statement.

Enhanced Information about Directors and Nominees

The SEC approved new rules to improve information about directors and nominees for director. For each director and director nominee, the new requirements include disclosure annually of:

- The particular experience, qualifications, attributes or skills that led the company's board to conclude that the person should serve as a director of the company at the present time (the time of the filing)
- Any directorships at public companies and registered investment companies that each director and director nominee held at any time during the past five years

The same disclosure is required with respect to any nominee put forward by another proponent.

Protiviti Commentary: Item 401 of Regulation S-K currently requires brief biographical information about directors and nominees for the previous five years. Item 407 requires general disclosure about director qualification requirements at a company. Currently, Regulation 407 requires disclosure of any specific minimum qualifications – as established by the nominating committee – which nominees for a position on the board must meet. The SEC’s amendments to Item 401 expand the information required about individual directors and supplement the current director qualification disclosures required by Item 407.

The Commission’s expanded rules require disclosure for each incumbent director and for each nominee for director – regardless of who nominated them – of the particular experience, qualifications, attributes and skills that qualify that person to serve as a director of the company. The objective of these revisions is to help investors determine whether a particular director or nominee as well as the entire board composition are an appropriate choice for a given company as of the time that the particular filing containing this disclosure is made with the Commission.

Several amendments were made to the proposing release. The final rules do not require disclosure of the specific experience, qualifications or skills that qualify a person to serve as a member of a standing committee of the board. The SEC was persuaded by commenters who argued that many companies rotate committee positions to allow directors to gain different perspectives of the company. In addition, some commenters noted the lack of standards by which qualifications of a director are determined and that service as a director involves many qualities, many of which are subjective.

The Commission decided not to specify the particular information that should be disclosed, electing to provide flexibility to issuers in determining a director's or nominee's skills, qualifications or other particular area of expertise that would benefit it and should be disclosed to shareholders. Accordingly, the SEC deleted the reference to a director's or nominee's "risk assessment skills." However, Commission stated that, if particular skills, such as risk assessment or financial reporting expertise, were relevant to a company's conclusion that a person should serve as a director, such skills should be disclosed. The Commission's primary objective with this particular disclosure is to enable shareholders and investors to assess Board composition and director qualifications in the context of the current challenges faced by the company.

Information about Board Leadership Structure

The SEC adopted a new disclosure requirement to Item 407 of Regulation S-K and a corresponding amendment to Item 7 of Schedule 14A that would require disclosure of the company's board leadership structure and why the company believes that structure is the best one for it at the time of the filing. The new rules would require the following disclosures in proxy and information statements:

- A company's board leadership structure, including whether the company has combined or separated the chief executive officer and chairman position, and why the company believes its structure is the most appropriate for the company at the present time (i.e., the time of the filing)
- In certain circumstances, whether and why a company has a lead independent director and the specific role of such director.

The Commission acknowledges that different leadership structures may be suitable for different companies depending on the company's size, the nature of its business, internal control considerations, among other factors.

The SEC's rules require that registered management investment companies must also provide the new Item 407 disclosures about board leadership structure and the board's risk oversight role in proxy and information statements. Similar to the transparency provided to investors in corporate issuers, the Commission is of the view that providing this disclosure to investors in investment companies would enable them to consider their management structure preference, if any, when deciding where to invest.

Protiviti Commentary: The SEC's objective is more transparency into the board's leadership structure. Under these new rules, companies would be required to disclose whether and why they have chosen to combine or separate the principal executive officer (CEO) and board chair positions. In addition, in those companies where the role of CEO and board chair are combined and a lead independent director is designated to chair meetings of the independent directors, the rules would require disclosure of why the company has a lead independent director as well as the specific role the lead independent director plays in the leadership of the company. Irrespective of the type of leadership structure selected by a company, the SEC

states that these rules are “intended to provide investors with insights about why the company has chosen that particular leadership structure.”

Note that the proposing release was adopted substantially as proposed, except that the term, “company leadership structure”, was changed to “board leadership structure.”

How Diversity Is Considered in the Director Nomination Process

The SEC approved a rule that would require disclosure of whether, and if so how, the nominating committee of the board considers diversity in identifying nominees for director. If the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, the final rules require disclosure of how this policy is implemented and how the nominating committee or the board assesses the effectiveness of the policy. For purposes of this disclosure, each company may define diversity as it sees fit considering such factors as professional experience, education, skill, differences of viewpoints, gender, race, national origin, etc.

Protiviti Commentary: As a specific topic raised by the comment letters to the SEC, diversity received as much discussion as, if not more discussion than, any other topic. There was widespread support for this disclosure and for diversity in general, with some commenters pointing to empirical support for the superior performance of companies with diverse boards.

Quicker Reporting of Voting Results

The SEC approved amendments to Form 8-K that would require companies to disclose the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. This replaces the requirement to disclose voting results in Forms 10-K and 10-Q, which often are filed months after the relevant meeting.

Previously, Item 4 in Part II of Form 10-Q and Item 4 in Form 10-K require the disclosure of voting results of any matter that was submitted to a vote of shareholders during the fiscal quarter covered by either the Form 10-Q or Form 10-K (which covers the fourth fiscal quarter). Under the Commission’s new rule, a new Item 5.07 would be added to Form 8-K to require a company to disclose on Form 8-K the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. Given this new requirement, the Commission deleted the corresponding requirement from Forms 10-Q and 10-K.

Protiviti Commentary: The SEC’s rationale for this rule is based on the fundamental belief that more timely disclosure of the voting results of an annual or special meeting would benefit investors and the markets. A key concern expressed with respect to the proposal is that disclosure of preliminary results could mislead investors if the voting is contested or is “too close to call.” Such situations could result in the definitive final results reflecting a different outcome than the preliminary results disclosed initially. Accordingly, some commenters suggested tying the disclosure requirement to the issuance of a certified report of an inspector of an election rather than to the end of a shareholders’ meeting. In response to this feedback, the SEC expanded the rules to require an amended 8-K filing within four days after the final voting results are known. Therefore, from a practical standpoint, if final voting results are not available, companies must disclose preliminary results on Form 8-K within four business days of the meeting, with final results reported on an amended Form 8-K later within four business days after the final determination.

Additional Information about Legal Actions

The SEC requires additional disclosure of legal proceedings, such as SEC securities fraud enforcement actions, against a company's executive officers, directors, and nominees for director, going back 10 years, instead of the current five years. It also provides an expanded list of legal proceedings covered by the rule to include the following:

- Any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity
- Any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement to such actions
- Any disciplinary sanctions or orders by a stock, commodities or derivatives exchange, or other self-regulatory organization

Protiviti Commentary: Commenters supported the extension of the required reporting period from five to ten years to provide more extensive information regarding an individual's competence and character to serve as a public official. For board nominees and candidates for executive positions, the company will need to align its due diligence background checks to address, at a minimum, the extended reporting period.

Revisions to the Compensation Tables

The SEC approved revisions to the reporting of stock and option awards in the Summary Compensation Table and the Director Compensation Table to better reflect the company's compensation committee's decisions with regard to these awards. The amended rule requires companies to report the value of stock awards and option awards when they are awarded to executives (the aggregate grant date fair value), instead of the current requirement to report the annual accounting charge recognized in the financial statements. The computation is to be made in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation – Stock Compensation (FASB ASC Topic 718), and needs to be provided for not only the current year data, but prior year data, as well. A special instruction addresses performance-based awards, requiring them to be reported at a value which is based on the "probable outcome", ostensibly to address concerns that the new rule might otherwise discourage use of these awards. Furthermore, there are situations in which, due to changes in the composition of executive officers, companies may have to report data for more than the required minimum number of officers for certain periods.

Protiviti Commentary: While these required revisions effectively "de-couple" the compensation tables from the financial statements for the same periods, they will, in the view of the SEC and many proponents, provide a clearer view of the value conveyed to executives and directors in the form of non-cash compensation. Companies should begin to prepare for these changes by assembling, preserving or re-computing the data necessary to re-cast prior year disclosures and prepare a template for the coming year's disclosures.

Enhanced Disclosure about Compensation Consultants

Many companies engage compensation consultants to make recommendations on the appropriate executive compensation levels, to design and implement incentive compensation plans, and to provide information on industry and peer group pay practices. These services can provide management and the board current information about compensation trends and benchmarks as well as regulatory requirements related to executive compensation.

The SEC has approved rules requiring disclosure about the fees paid to compensation consultants and their affiliates in certain circumstances. This disclosure is intended to provide investors with information to help them better assess the potential conflicts of interest a compensation consultant may have in recommending executive compensation. The final rules are consistent with the rule proposal, but include exceptions for circumstances that should not raise the potential for conflicts of interest.

In summary, in addition to the requirement under the current rule to describe the role of the compensation consultant in determining or recommending the amount or form of executive and director compensation, fee disclosure related to the retention of the consultant will be required in certain circumstances. The SEC's final rules are generally as follows:

- If the board, compensation committee or other persons performing the equivalent functions (collectively "the board") has engaged its own consultant to provide advice or recommendations on the amount and form of executive and director compensation and the board's consultant or its affiliates provide other non-executive compensation consulting services to the company, fee and related disclosure is required, provided the fees for the non-executive compensation consulting services exceed \$120,000 during the company's fiscal year. Disclosure is also required of whether the decision to engage the compensation consultant or its affiliates for non-executive compensation consulting services was made or recommended by management, and whether the board has approved such non-executive compensation consulting services.
- If the board has not engaged its own consultant, fee disclosures are required if there is a consultant (including its affiliates) providing executive compensation consulting services and non-executive compensation consulting services to the company, provided the fees of the non-executive compensation consulting services exceed \$120,000 during the company's fiscal year.
- Fee and related disclosure for consultants that work with management (whether for only executive compensation consulting or for both executive compensation consulting and other non-executive compensation consulting services) is not required if the board has its own consultant.
- Services involving only broad-based non-discriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant, are not treated as executive compensation consulting services for purposes of the SEC's rules.

Protiviti Commentary: Historically, public companies have not been required to disclose the fees paid to compensation consultants and their affiliates for executive compensation consulting or other services, or to describe services that are not related to executive or director compensation. These final amendments to Item 407 of Regulation S-K were toned down considerably from the proposing release. Several commenters, primarily multi-service compensation consulting firms, opposed the proposal on several grounds. The SEC was persuaded that there are circumstances where the fee disclosure was not required either because of the limited nature of the additional services or because of other factors that mitigate the concern that the board may be receiving advice potentially influenced by a conflict of interest. In addition, disclosure of the nature and extent of all additional services provided to the company or its affiliates during the last fiscal year by either the compensation consultant or any of its affiliates, as originally proposed, was not required in the final rules as it was deemed by the SEC to cause competitive harm to the consulting firms. The final rules reflect how the SEC dealt with these concerns.

Summary

In the Commission's press release, SEC Chairman Mary L. Schapiro stated:

Good corporate governance is a system in which those who manage a company — that is, officers and directors — are effectively held accountable for their decisions and performance. But 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.

These statements by Ms. Schapiro reflect the SEC's focus on corporate accountability and the need of investors for additional information that would enhance their ability to make informed voting and investment decisions.

About Protiviti

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