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Risk-taking, Diversity, and Director Qualifications: More on the New SEC Proxy Disclosure Rules

Corporate Board Member *recently spoke with Andrew C. Liazos and David Cifrino with McDermott Will & Emery LLP about new SEC rules, effective Feb 28th, and their impact on the upcoming proxy season.*

***Corporate Board Member*: Why are there new proxy disclosure rules relating to risk taking and compensation programs?**
Andrew Liazos: Many blame executive compensation programs for the excessive risk-taking at certain financial institutions that lead to the recent financial crisis. Companies accepting TARP funds are expressly prohibited from adopting incentive programs for named executive officers that encourage excessive risk taking. Instead of including an outright prohibition against excessive risk taking, new SEC proxy disclosure rules require disclosure if compensation programs create risks that are “reasonably likely” to have a “material adverse affect” on a public company.

CBM: But would any company admit to encouraging excessive risk taking through its compensation structure?
AL: Presumably few public companies will reach that conclusion. An important impact of this rule change is that a significant amount of time and money will need to be expended in many cases in order to be able to demonstrate that a company’s compensation programs do not encourage excessive risk taking. It is not uncommon now to see companies hiring consultants and law firms to assist with this analysis. Other companies will try to handle this matter themselves through the audit committee. But it’s too early to tell what will emerge as the predominant practice for making this assessment and allocating responsibility among board committees and management. Compensation committees will be sensitive to situations in which an executive has large upside from an incentive package with limited downside for poor business decisions.

You’ll also see companies highlight in their proxies the aspects of their compensation programs that mitigate the likelihood of excessive risk-taking. Program features likely to be emphasized are so-called clawback arrangements, in which the company has a right to recover prior incentive compensation payments due to certain types of misconduct, stock ownership guidelines that require executives to hold significant amounts of equity (so that executives have downside risk), dollar limits on incentive compensation, and smaller (or no) stock option grants. Shareholder advisory service RiskMetrics Group has already said it will conduct its own risk assessments, and it’s reasonable to assume many companies will want to point out their compensation program strengths.

David Cifrino: If a company doesn’t say that it has any such risks—and the rule doesn’t require that it say so if it concludes that it doesn’t—the SEC has said it will ask the company to explain what process was used to make that determination. So, as is often the case with governance, process is as important as substance.

CBM: Compensation consultants have been thrown into upheaval with the new requirements. What are the new requirements and how will they affect compensation committees and consultants?
DC: The new rules require public companies to disclose compensation consultant fee amounts if they have a compensation consultant advising on executive and director compensation and also more than $120,000 of business for the company other than advising on executive and director compensation. This rule is aimed at disclosure of potential conflicts of interest.

AL: There is already a tremendous amount of change as a result of this rule change. As David mentioned, the SEC is concerned about potential conflicts of interest when consultants are advising compensation committees. This movement can be traced to a New York Times article by Gretchen Morgenstern about three years ago which suggested that compensation committees were hiring large consulting firms that received most of their fees from rendering other services to management. So the question became, were these consultants really working for the compensation committee or were they beholden management due to ancillary service arrangements? The SEC has tackled this issue by requiring disclosure of what it considers to be material levels of ancillary services provided on behalf of management. Currently, there is proposed legislation requiring the compensation consultant to be independent. As a result of these developments, we are beginning to see growth in compensation consulting firms that only provide executive compensation services to compensation committees.

DC: Some compensation consulting firms are spinning the executive compensation advisory services groups off into independent companies.

AL: One issue to be aware of is what happens when a consultant is with more than one firm for a year. For example, Towers Perrin and Watson Wyatt merged last year. So, if a public company received services with respect to Watson Wyatt on compensation consulting and Towers Perrin did the benefits consulting, what do you do? There will be several transitional issues like this to consider, and I think you'll continue to see more compensation committees using advisors who are considered to be independent.

CBM: Directors' qualifications will now have to be defended, too.
DC: This is the interesting sleeper in these new rules which basically asks companies to disclose why every continuing director's particular and specific experience, qualifications, attributes or skills led the board to conclude that person should serve as a director, either as a new nominee or as a continuing director. This leads to the increasing professionalism of boards of directors, and it may be that some board members are found not to measure up—that it's no longer good enough just to make a good martini, play a good round of golf, or be a third cousin of the founder.

CBM: And diversity will perhaps become more of an issue, too, right?
DC: It's less clear what may happen with diversity because the new SEC rule provides that a company can define diversity any way it chooses and all it has to do is explain whether it has a policy with regard to diversity on its board, and if so, how does it implement that policy? Some companies, in their corporate governance guidelines, may say something as simple as "we seek to have a diverse board." Other companies go further to say "we like to have diversity with regard to gender, race, religion, sexual orientation, etc." and then the question would be well what do they do to actually implement that when they consider various candidates? For years many stockholder

proposals sought for companies to adopt overall diversity policies. I think many companies, if not most public companies of substantial size, have done that. Because the SEC chose not to define diversity in any particular way, I think it's too soon to tell what kind of difference this may make with regard to board composition.

CBM: How will these rules affect the upcoming proxy season?
DC: I think most companies will not find it too difficult to negotiate these new disclosure requirements. A lot of them are factually based. As far as the requirement to describe the company's risk oversight, most companies have pretty robust enterprise risk management programs. And to the extent that they don't, they may, because of these disclosure requirements, take a harder look at their enterprise risk management programs and decide to allocate responsibilities somewhat differently.

In terms of negotiating the enhanced director qualifications disclosure, companies are going to have to source better information from each of the directors and from the directors collectively as to what they consider. So there's some additional drilled down detail processes needed, but I don't think it's a dramatic effect on how companies will operate with regard to preparing their proxies. Now, how might shareholders react to these new disclosures? I think they'll look at this as helpful information overall.

AL: Another item to be on the lookout for is the new rule for disclosing equity compensation grants in the summary compensation table. Back in December 2006, the SEC decided to require companies to report the cost of stock option and restricted stock based on accounting rules. As a result, the amount of cost allocated to a particular year was determined based on accounting measurement concepts that really did not bear much relationship to compensation principles. For example, the cost of a grant to a retiring executive might be considered to be several times more than for another executive even though the grants were identical. For proxies filed after February 2010, all of the grant date value for an equity award is allocated entirely to the year of grant (and not spread over the vesting period), and this must be done for the 2007 and 2008 for the named executive officers in this year's summary compensation table. While this approach is simpler and allows for easier comparison of practices among companies, it will also inflate the total compensation of named executive officers in a manner that could be misleading. So that's something to be sensitive to, particularly when executives hold a large amount of underwater stock options. I suspect that some companies will include additional tables to their proxies to illustrate the difference between current value and total compensation based accounting costs.