SEC Adopts New Public Company Disclosure Requirements About Risk, Corporate Governance and Compensation

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The Securities and Exchange Commission believes that public company investors are increasingly concerned about corporate accountability. To enhance investors' ability to make informed voting and investment decisions, and help them evaluate company leadership, on December 16, 2009, the SEC adopted rules requiring new disclosures about risk, corporate governance and compensation. The rule changes generally apply to filings on or after February 28, 2010, so calendar year-end companies planning to file their 2010 proxy statements in March or April must take these changes into account. The full text of the adopting release is located at http://sec.gov/rules/final/2009/33-9089.pdf.

What are the key take-aways for technology companies?

- Technology companies – accustomed to assessing business risks on an everyday basis – will now grapple with risk-related disclosures about more abstract issues, such as whether their compensation practices create risks that may adversely affect the company, and how the board administers its basic risk oversight function.
- Maturing technology companies must give fresh thought to major corporate governance items, such as qualifications of individual board members, diversity considerations in selection of director nominees, and the reasons for the company's board leadership structure.
- Equity award valuation changes may lead to surprises in the named executive officers identified for annual disclosures, and historical summary compensation table information will be restated.
- Given the timing of these rule changes, companies must pay attention to elements of their annual disclosure process, such as updating the D&O questionnaire, allowing additional time to socialize new disclosure language, and setting up a Form 8-K disclosure process for annual meeting voting results.

What's new with respect to disclosures about risk?

The SEC adopted rules that require new disclosure about the board's role in risk oversight and, to the extent that risks arising from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company, disclosure about those policies and practices as they relate to risk management.

Board Role in Risk Oversight

As part of new disclosure about the board leadership structure, discussed below, companies are now required to discuss the board's role in the oversight of risk, and the effect this has on the board's leadership structure. Regulation S-K, Item 407(h). This risk oversight disclosure is expected to give investors insight into how the company perceives the role of the board, and its relationship to company management, in managing material risks facing the company (*e.g.*, credit risk, liquidity risk and operational risk).

Risk and Compensation

The SEC approved a new Item 402(s) under Regulation S-K, requiring narrative disclosure of the company's compensation policies and practices for all employees – not just executive officers – if those policies and practices create risks that are *reasonably likely* to have a *material adverse effect* on the company. We would expect this to be a relatively rare result at most technology companies, and the relatively high disclosure threshold should help prevent mere boilerplate disclosure. However, each company must go through the process of assessing the issue in order to have a basis for nondisclosure (smaller reporting companies are exempt, but may wish to assess the risk in any event). The purpose of this disclosure

is to help investors identify whether the company's compensation policies seem likely to lead to excessive or inappropriate risk taking by company personnel. The company is also permitted to take into account policies, such as stock retention or bonus clawback policies, which mitigate other pay practices that could lead to inappropriate risk-taking.

The SEC believes that discussion about compensation that poses a material risk might be appropriate, for example, in connection with policies and practices:

- At a business unit that carries a major portion of a company's risk profile;
- At a business unit with compensation that is structured differently than other parts of the company;
- At a business unit that is more profitable than other parts of the company;
- At a business unit where compensation expense is a large percentage of the unit's revenue; and
- That vary with the overall risk and reward structure of the company, such as when a bonus is paid in a current year but the risk to the company extends over a longer period of time.

While these new risk-related disclosures may seem peculiarly geared to companies in the financial services industry, in fact the disclosure requirement applies to all public companies. Each company will naturally focus on whether its compensation policies – for executives and for other employees – create risks of a material adverse effect on the company. Since this is not an exercise that most companies have conducted in a formal manner historically, additional time will be required to conduct the assessment this year, and document the conclusions. The narrative disclosure about risk associated with overall compensation programs is not part of Compensation Discussion and Analysis, but you should consider whether your CD&A disclosure should be modified to reflect any conclusions about risk associated with executive compensation.

What's new with respect to disclosures about corporate governance?

The SEC has expanded disclosure of the background and qualifications of directors and director nominees, and required new disclosure about how diversity is considered in director nominations, as well as about the company's board leadership structure. In addition, it amended Form 8-K to include prompt mandatory reporting of information about shareholder voting results.

Information about Directors and Nominees

The SEC approved new rules intended to provide investors with more information about the background of directors and director nominees, to help investors making voting decisions determine whether and why a director or nominee is an appropriate choice for the company's board of directors. The disclosure is required for all directors and nominees, including members of a staggered board who are not up for election at the current meeting. Under Item 401 of Regulation S-K as amended, companies must discuss the specific experience, qualifications, attributes or skills that qualify each director or nominee to serve as a director. This new disclosure is in addition to existing requirements to disclose any specific minimum qualifications for any director recommended by the nominating committee for a seat on the board. In addition, disclosure of other public company directorships during the past five years must also be included (formerly, only current directorships were required). Finally, the look-back period for disclosure of involvement in specific types of legal proceedings was extended from five years to ten years, and the scope of legal proceedings required to be disclosed was expanded.

How Diversity is Considered in Director Nominations

New language in Regulation S-K Item 407(c) requires disclosure of whether the board's nominating committee considers diversity in identifying nominees for director, and if so, how. If the nominating committee or board has a policy about how diversity is considered, the company must describe how it is implemented or how the board assesses the effectiveness of its policy.

Board Leadership Structure

Regulation S-K Item 407(h) requires disclosure of the company's board leadership structure, including whether the same person serves as the Chief Executive Officer and the Chairman of the Board. Where one person serves as both CEO and Chairman, companies must disclose whether they have a lead independent director, and what specific role he or she plays in board leadership. The disclosure should include why the company believes its structure is appropriate, given the company's specific circumstances.

Form 8-K Reporting of Stockholder Voting Results

The SEC approved amendments to Form 8-K, requiring companies to disclose results of a shareholder vote within four business days. Formerly, voting results were disclosed in quarterly or annual reports, which might lag the meeting by a considerable time. Under Form 8-K Item 5.07, preliminary voting results must be reported if final results are unavailable, and an amended report must be filed within four business days after the availability of final results.

What's new with respect to disclosures about compensation?

The SEC has revised the reporting of equity awards in the Summary Compensation Table and the Director Compensation Table, and required new disclosure of potential conflicts of interest of compensation consultants in some circumstances.

Compensation Table Disclosure of Equity Awards

The SEC revised the manner in which equity awards are reported in the Summary Compensation Table and Director Compensation Table. Going forward (for fiscal years ending on or after December 20, 2009), these tables will show the value of stock and option awards when they are awarded (aggregate grant date fair value), instead of the current requirement to report the accounting charge recognized for all equity awards in the year. This change was designed to highlight the effects of the board's decisions about equity awards on an annual basis, just as the table generally reflects non-equity compensation decision-making for the year. To enable year-over-year comparison of Summary Compensation Table information, amounts must be re-computed for each historical year presented. This will affect the amounts shown for stock awards, option awards and total compensation. Note that for performance grants, the table should reflect value based on the most probably outcome, while footnote disclosure should include maximum performance outcomes.

Aggregate grant date fair value of equity awards is often significantly greater than the amount recognized in a year, so you should keep in mind that a newly hired officer, or an executive officer receiving an extraordinary refresh grant, may become one of the most-highly compensated executive officers for the year, and so would be a "named executive officer" appearing in the executive compensation disclosure tables. For some companies it may be appropriate to include disclosure about an executive who would normally be in the table except for the impact of an extraordinary equity grant on the determination of named executive officers. It is important to identify your named executive officers early, so that you will be able to collect all the information required to be disclosed about each of them.

Compensation Consultants

The SEC adopted new rules requiring disclosure of fees paid to compensation consultants, under the following circumstances:

- If the board or compensation committee has engaged its own compensation consultant, and this consultant (including affiliates) also provided additional services to the company in an amount in excess of $120,000 during the fiscal year; and
- If the board or compensation committee has not engaged its own compensation consultant, but a compensation consultant (including affiliates) provided executive compensation consulting services and additional services to the company in an amount in excess of $120,000 during the fiscal year.

No disclosure is required for consultants that work with management (without regard to the nature of the engagement) if the board of directors has its own (different) consultant. The purpose of this disclosure is to provide investors with information

to help them assess potential conflicts of interest that a compensation consultant may have when recommending executive compensation. No disclosure would be required where the compensation consultant advised only with respect to broad-based plans that do not discriminate in favor of executives, such as heal insurance or 401(k) plans.

The full text of the release is located at http://sec.gov/rules/final/2009/33-9089.pdf.

For more information on this or related matters, please contact: Horace Nash at 650.335.7934 or hnash@fenwick.com; or Scott Spector at 650.336.7251 or sspector@fenwick.com.

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