

THE SPOTLIGHT ON REVISED EXECUTIVE COMPENSATION DISCLOSURES

Compensation decisions remain under scrutiny by investors. As investors demand that executive pay be linked to performance, issuers and the SEC are still struggling with the “new” executive compensation disclosure rules first effective four years ago. Now the SEC has amended the executive compensation disclosure rules impacting the disclosure required in the proxy materials for the 2010 annual meeting. The new disclosure requirements are generally directed at two main areas: risk analysis and compensation consultants independence.

Risk Analysis

The new rules require that the company disclose information regarding compensation policies and practices that are likely to expose the company to material risk. The disclosure will encompass the company’s overall compensation policies or practices *for all employees*, not just executive officers. In addition, the disclosure must include compensation policies and practices that create risks that are *reasonably likely* to have a material adverse effect on the company. Practically, the SEC has indicated that this *reasonably likely* standard will have the same threshold as used in the MD&A rules. Companies must be keenly aware of how their compensation incentivizes its employees.

Companies must be prepared to explain how the compensation policies and practices affect the company's risk and management of risk. Specific areas of review may include the portion of compensation that is incentive-based, length of vesting periods and performance goal levels relative to past performance as well as payout curves. Risk Metrics has added its own list of indicators that may encourage excessive risk taking including guaranteed bonuses and lucrative severance packages among others. In assessing whether disclosure is required, companies may consider controls and other factors that are designed to limit risk.

The SEC has made clear that this new disclosure is not to be part of the CD&A. In addition, a company need not make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company. Disclosure is required only when such a determination has been made.

The new rules provide a non-exhaustive list of situations where employee compensation policies and practices may have the potential to raise material risks to a company possibly resulting in the need for disclosure. However, even in these situations the company must determine that the risks are reasonably likely to have a material adverse effect on the company. These include situations where a business unit:

- carries a significant portion of the company’s risk profile;
- has compensation structured significantly differently from other units;
- is significantly more profitable than others;

- has compensation expense representing a significant percentage of its revenues; or
- has compensation policies and practices that vary significantly from the overall risk and reward structure of the company.

In the event disclosure is required, the SEC expects the company to take a “principles-based” approach and consider the “illustrative examples” set forth in the new rules to provide meaningful disclosure highlighting the relationship between the compensation policies and practices and the risk profile. Companies must be prepared to explain its pay determinations.

Recommended Actions:

- Review and understand the relationship between the company's compensation policies and practices at all levels and company risk
- Consider whether outside experts need to be consulted to assist with this review
- Pay specific attention to whether any areas highlighted in the SEC rule exist and, if so, assess the risk of those situations
- Continue to consider the incentives provided executives, especially NEOs, and any related risks, providing appropriate discussion and analysis of any material risk-related issues in the CD&A

Compensation Consultants

The SEC adopted the new rules regarding compensation consultants in an effort to provide investors with information to better assess possible conflicts of interest the consultants may have in recommending executive compensation and compensation decisions. The new rules supplement disclosure relative to board compensation committees to require enhanced disclosure of fees paid to certain compensation consultants that provide advice to the board or compensation committee regarding executive or director compensation and also provide other services to the company.

If the board or compensation committee has engaged its own consultant to provide advice regarding executive and director compensation and the consultant or its affiliates provide other non-executive compensation consulting services to the company in excess of \$120,000 during the fiscal year, then the company is required to disclose:

- the aggregate fees paid for advising on the amount or form of executive and director compensation and the amount paid for the additional services;
- whether the decision to engage the consultant or its affiliates for such additional services was made by or recommended by management; and
- whether the board or compensation committee approved the other services.

If the board or compensation committee has not engaged its own compensation consultant, but management has retained a consultant to advise on amounts or forms of executive compensation and the consultant or its affiliates provides other services to the company in excess of \$120,000 during the fiscal year, the company is required to disclose the aggregate fees paid for advising on executive compensation and for the other services.

The rules contain exceptions for services provided by compensation consultants involving only broad-based non-discriminatory plans or providing information, such as surveys, that are not customized for the company or are customized based on parameters developed by someone other than the consultant.

Recommended Actions:

- Review all services provided by current consultants including both compensation advice and other matters considering whether disclosure is required in the 2010 proxy materials
- Review policies and procedures regarding the retention of consultants, considering whether to adopt a policy requiring compensation committee approval prior to the engagement of compensation consultants

Stock and Option Awards Disclosure

The Summary Compensation Table and Director Compensation Table disclosure requirements are amended to require companies to report the value of stock and option awards made during the fiscal year based upon their aggregate grant fair value computed in accordance with applicable financial accounting standards. This would replace the former requirement of reporting the dollar amount recognized as an expense for financial statement reporting purposes for the fiscal year and will affect the calculation of total compensation, including for purposes of determining NEOs. For performance based awards, the value should be computed based upon the probable outcome of the performance condition assessed as of the grant date and footnote disclosure is required of the award's maximum value assuming the highest level of performance.

The company will use this value to identify the current year's NEOs and will be required to apply this method to re-compute the value of compensation reported for those named executive officers in the Summary Compensation Table for the last two fiscal years, to the extent that compensation information for those years is required with respect to the NEO.

Recommended Actions:

- Annually assess whether using grant date fair value will change the NEOs
- Commence drafting the summary compensation table reflecting the new valuation method

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