A New Era of

What accountants and financial professionals need to know about changes in proxy statement disclosures

By Jan Taylor Morris, CPA; Frank Grippo, CPA; and Noah Barsky, CMA, CPA

With more than 600 billion shares voted every year at more than 13,000 investor meetings, shareholder expectations of corporate accountability have increased dramatically. Accordingly, proxy statement disclosures are now significantly different from the "boilerplate" documents of the past. Sweeping changes from the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act and recent and forthcoming guidance from the U.S. Securities & Exchange Commission (SEC), such as "Proxy Disclosure Enhancements," require significantly more disclosure about risk oversight, board governance, and executive compensation.

Risk Oversight

Boards of directors are not and should not be involved in the operation of a company's risk management system, yet one of a board's primary functions is to properly define, oversee, and monitor the effectiveness of this system. To help clarify this role, recent changes associated with board oversight of risk management have been put into effect. First, the Dodd-Frank Act changed the risk management oversight responsibility for boards of large bank holding companies and other nonbank financial companies. The Act mandated that these boards form a separate risk committee with at least one risk management expert as a member. Second, the SEC now requires a proxy statement discussion of a company's board leadership structure and its role in risk management oversight.

In this discussion, companies must more clearly disclose and explain the board's role in risk management oversight, and they must detail whether the entire board or a committee performs this function. Moreover, companies have to indicate whether those responsible for risk management report directly to the entire board or to a committee, such as the risk committee or audit committee. The SEC also expects a discussion of the timing, nature, and extent of risk monitoring in the proxy statement. Referring to these changes in proxy disclosures, SEC Chairman Mary Schapiro suggested in a 2010 speech at Stanford University that there had been a "divergence of approaches when it comes to disclosure of risk" and that that fuller disclosure of risk management both informs and reassures investors. (You can read her speech at www.sec.gov/news/speech/2010/spch062010mls.htm.)

In addition to proxy statement disclosures about the board's role in risk management, companies must also discuss the extent to which risks arising from their compensation policies and practices are likely to have a "material adverse effect" on the company. This requirement relates to all employees, not just executive officers, and the rule provides a nonexclusive list of scenarios where employee compensation plans may create incentives that increase overall risk.

For example, these scenarios include policies that are

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in place at several business units of a company, which often differ significantly from each other in size, scope, profitability, and overall risk. The SEC is especially concerned with identifying where a strategic business unit's compensation differs from compensation in other parts of the enterprise, where compensation expense is a significant portion of the unit's revenues, or where time constraints relating to pay and performance differ dramatically. To avoid unintended consequences in such cases, the SEC now expects companies to "discuss" their compensation philosophy, basis for promoting varied compensation incentives, monitoring, and controls in place (such as deferrals or payment reversals). Various comments from SEC leaders suggest that the Commission will be monitoring this matter very closely in coming years.

Governance

In an effort to provide assurances about the credibility of risk management, the SEC also now expects more detailed disclosure in proxy statements about the background and qualifications of current and nominated directors and the company's leadership structure. The company must disclose the particular experiences, qualifications, attributes, or skills that led to a director's appointment or nomination. Further, it must explain why its board leadership structure is appropriate for the company and its risk oversight responsibilities. (This is part of the "Proxy Disclosure Enhancements.")

In the discussion of board structure, a company has to clearly articulate plans to combine or separate the positions of CEO and board chair. If a company combines the positions, the requirements call for it to disclose the selection of a "lead" independent director and the responsibilities of that individual. Although combining the CEO and chair positions has been a common practice in the United States, with approximately 60% of the S&P 500 doing so, according to Deloitte's May 2011 report "Board Leadership: A Global Perspective," critics of this practice suggest that it leads to natural conflicts of interest because the CEO manages the company and the chair leads the board in its responsibility for oversight (hiring, compensating, and replacing) of the CEO. With this rule, the SEC appears to be moving in the direction of guidance from countries such as the United Kingdom that require separation of the two roles.

Boards also must disclose any other directorships held by directors at the time the proxy is issued and in the preceding five years. Such data gives shareholders insight into directors' experiences, workload, and potential conflicts of interest. Also, the "lookback" period related to disclosures about legal proceedings involving current and nominated company officers has been extended from five to 10 years. The definition of legal concerns has been broadened to include any fraud, violations of securities laws, and disciplinary actions of any type by securities exchanges.

Executive Compensation

On January 25, 2011, the SEC adopted rules concerning shareholder approval of executive compensation and "golden parachute" compensation arrangements to implement Section 951 of the Dodd-Frank Act. The type, approval, and design of executive compensation has always been an issue for boards of major companies, and debate over the issue isn't new. This ruling required companies subject to the federal proxy rules, regardless of size, to provide shareholders with an advisory vote on executive compensation at the first shareholder meeting held on or after January 21, 2011. The companies had to include three nonbinding shareholder votes known as "say-on-pay," "say-on-frequency," and "say-on-golden parachutes." Say-on-frequency votes must be held at least once every six years to determine the timing of say-on-pay votes. Say-on-pay votes may be held every year, every two years, or every three years. Companies that are recipients of the Troubled Asset Relief Program (TARP) are required to hold annual say-on-pay votes and waive say-on-frequency until they repay the TARP funds.

Say-on-pay votes must include the compensation of the company's "named" executive officers whose compensation is disclosed in the proxy statement. Director compensation isn't subject to this vote. Companies that issue a Compensation Discussion and Analysis in their proxy must specifically discuss how they considered shareholder advice in compensation decisions. Further, companies were required to file an amended 8-K within 150 days of their say-on-frequency vote to explain the board's decision about say-on-pay frequency. In February 2012, the SEC reported that while most complied with the required 8-K filing after the "frequency" vote, hundreds of companies failed to follow up with the amended 8-K. The first year that say-on-pay votes were required was 2011, and a majority of shareholders voted in favor of executive compensation plans at more than 98% of large public companies. Further, an overwhelming majority of shareholders voted for annual review of these compensation plans.

SEC Item 402(t) of Regulation S-K details new "golden parachute" disclosure requirements, including tabular and narrative disclosures of "golden parachute" merger-related compensation. These disclosures relate to any compensation (present, deferred, or contingent) that a named executive (with either the acquiring or target company) would receive that are based on or otherwise relate to the merger, acquisition, or similar transaction. The table will detail cash severance, equity awards that are accelerated or cashed out, pension and nonqualified deferred compensation enhancements, perquisites, tax reimbursements, and any other compensation related to the transaction. The narrative disclosures would describe the agreements, including material conditions attached to them, such as noncompete clauses, specific circumstances that would trigger payments, and length of payment terms. This Item requires compensation related to mergers or similar transactions to be disclosed in a proxy statement seeking shareholder approval of the transaction, but it doesn't require (but does allow) disclosure in annual meeting proxy statements. (See www.sec.gov/rules/final/2011/33-9178.pdf.)

Amgen Policy on Executive Compensation in Restatement Situations

"In the event of a material restatement of the Company's financial results, the Board of Directors, or the appropriate committee thereof, will review all bonuses and other incentive and equity compensation awarded to the Company's executive officers on the basis of having met or exceeded performance targets for performance periods that occurred during the restatement period. If such bonuses and other incentive and equity compensation would have been lower had they been calculated based on such restated results, the Board of Directors, or the appropriate committee thereof, will, to the extent permitted by governing law and as appropriate under the circumstances, seek to recover for the benefit of the Company all or a portion of such bonuses and incentive and equity compensation awarded to executive officers whose fraud or misconduct caused or partially caused such restatement, as determined by the Board of Directors, or the appropriate committee thereof. In determining whether to seek recovery, the Board of Directors, or the appropriate committee thereof, shall take into account such considerations as it deems appropriate, including governing law and whether the assertion of a claim may prejudice the interests of the Company in any related proceeding or investigation. All bonuses and other incentive and equity compensation will be awarded to executive officers with notice that such compensation is subject to this policy." www.amgen.com/about/corporate_governance_executive_compensation.html.

The SEC has delayed its schedule for adopting rules on four principal executive compensation issues required by the Dodd-Frank Act until sometime this year. As such, rulings on the following items won't be in place for the 2012 proxy season: (1) pay vs. performance disclosure; (2) required compensation clawback policies; (3) CEO pay comparison, which requires an "internal pay equity" disclosure showing the relationship between the CEO's annual compensation and the median total annual compensation of employees other than the CEO; and (4) disclosure of hedging policies, which will require disclosure about whether directors and employees are permitted to enter into financial agreements designed to hedge against a decrease in market value of the company's shares.

Pay vs. Performance. The Dodd-Frank Act requires disclosure of information in the Compensation Discussion and Analysis section of the annual proxy that addresses the relationship between executive compensation actually paid and the financial performance of the company. The company's financial performance must include any change in the value of the company's stock and dividends or other distributions. The general presumption is that financial performance will be computed based on cumulative total shareholder return (similar to the performance graph in current proxy statements). Problems that may have caused the SEC to delay adopting this rule include the definition of "compensation actually paid," determining if the disclosure applies to all executives in the Section 16 group or only named executives, and determining over what period the provisions apply.

Ideally, once the compensation disclosures are required, they will provide shareholders with insights into how incentive compensation motivates specific executive action and the achievement of key targets. Changes in proxies have been limited and inconsistent to date because guidance is still being formulated.

Clawback Policies. The Dodd-Frank Act also required the SEC to direct national securities exchanges and associations to issue listing standards that require companies to implement "clawback" policies. Compensation recovery—or clawback provisions—enable companies to recover from current and former executives any bonus compensation paid during the three years preceding any financial restatement the company had to do because of material violations of Generally Accepted Accounting Principles (GAAP). The "clawback" relates specifically to any excess compensation paid above the performance reported in the restated financial statements. The SEC also must adopt rules that require the issuer to develop a policy relating to disclosure of the clawback policy, presumably in the annual proxy statement. As noted, the SEC plans additional rules and guidance in 2012 related to the required clawback disclosures or for changes for companies, such as Amgen, that have long held such policies. (See "Amgen Policy on Executive Compensation in Restatement Situations.")

A New Era of Accountability

The new rules and regulations mandated by the Dodd-Frank Act and the SEC ushered in a new era of accountability for risk oversight, board governance, and executive compensation. Transparency appears be the main goal of these increased disclosures. As such, board practices related to risk oversight should continue to progress, companies should continue to examine and review corporate governance structures, and boards and shareholders should monitor executive compensation packages. SF

Must Reading for Financial Professionals!

What does 2012 hold? Each year, at the close of the proxy season (usually by August), Institutional Shareholder Services publishes its annual Postseason Report. The Report reviews investor voting on compensation, director elections, shareholder proposals on governance issues, and environmental and social resolutions. It also provides interesting insights into current market trends. You can download it for free at www.issgovernance.com.

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