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SEC and RiskMetrics Group Seek Greater Explanation of Compensation Risk Assessments in 2010 Proxy Statements

Background

On December 16th, the Securities and Exchange Commission (SEC) approved amendments to the proxy disclosure rules in order to enhance the disclosure provided to shareholders of public companies regarding compensation and corporate governance matters. According to the amended SEC rules, discussion and analysis of the risks of compensation policies and programs for employees (not just named executive officers) are required only if the risks are “reasonably likely to have a material adverse effect on the issuer.” No specific guidance was provided regarding how such a determination would be made, and there is no requirement to disclose the existence or nature of the processes used if the issuer determines that no material adverse risks were present.

Since the adoption of the revised disclosure rules, many companies have undertaken some level of analysis or review of their compensation policies and programs. For companies that have determined that no material adverse risks are present, corporate governance advisors have different views with regard to saying nothing (as clearly permitted by the SEC rules) vs. affirmatively stating that the risks of a corporation’s incentive plans are not reasonably likely to have a material adverse effect along with some explanation of the process employed to reach this conclusion.

Recent Guidance from the SEC and RiskMetrics Group

At a recent conference, the SEC Division of Corporation Finance staff indicated that, if a company’s proxy statement is selected for review by the SEC, the company will be asked to explain the process used to determine that no material risk exists in incentive plans, if no such disclosure is provided in the proxy.

In addition, RiskMetrics Group (RMG) recently expressed a view that voluntary disclosure should be an opportunity for better communication with shareholders. They are advising issuers to, at a minimum, discuss their evaluation process and the presence of any mitigating features (e.g., claw-backs or bonus banks) that have been adopted. Their preference is for issuers to provide a reasonably substantive discussion of the board’s process to determine whether the company's incentive pay programs might motivate “inappropriate risk-taking,” and any steps taken to mitigate such risks.

These developments should encourage companies to conduct a formal risk assessment of its programs and policies in order to appropriately respond to formal SEC comments and potential RMG criticism. We expect to see a number of different approaches this year as issuers struggle with developing appropriate procedures.

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General questions about this letter may be directed to Michael Marino in our New York office at (212) 299-3598 or by email at mrmarino@fwcook.com, or James Kim in our San Francisco office at (415) 659-0202 or by email at jekim@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.