



Public Policy Alert

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SEC's Proposed Rule Would Reshape Disclosure of Compensation Policies, Governance Structure and the Board's Role in Risk Oversight

Companies and their boards could face substantial new disclosure requirements as early as FY2010 as a result of the amendments recently proposed by the Securities and Exchange Commission (SEC) to rules affecting broad compensation policy and corporate governance disclosures.¹

Directly tying compensation policies with risk outcomes for the first time, the new proposal joins other recent legislative proposals that seek to reshape compensation and governance structure disclosures as well as strengthen board accountability for risk oversight.

While this proposal is still in the comment stage, it is yet another sign of Washington, DC's growing interest in executive compensation, leadership accountability, and risk management in the wake of the financial crisis. The

proposed "Shareholder Bill of Rights,"² Treasury's Investor Protection Act of 2009³, and Congress' Corporate and Financial Institution Compensation Fairness Act of 2009⁴ (see the latest development on page 4), along with the themes outlined in the president's white paper on financial regulatory reform,⁵ together indicate that the interplay of oversight, risk, and compensation will ultimately be the subject of both domestic and international rule-making and should be addressed proactively.

Understanding the SEC Proposal

The proposed rule would require public companies and, in some cases, registered investment companies to enhance their disclosures related to:

- Overall compensation policies (not just executive compensation) and their impact on risk taking;
- Stock and option awards of executives and directors;
- Director and nominee qualifications;

¹ <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>

² http://www.us.kpmg.com/RutUS_prod/Documents/12/20806NSS_Public_Policy_Alert_v2.pdf

³ <http://www.ustreas.gov/press/releases/docs/tg205071009.pdf>; and KPMG LLP Regulatory Practice Letter, "Proposed Legislation to Strengthen Investor Protection through Shareholder Votes on Executive Compensation," RPL Number 09-26, July 22, 2009.

⁴ http://www.thomas.gov/home/gpoxmlc111/h3269_jh.xml

⁵ <http://www.us.kpmg.com/microsite/Attachments/financial-regulatory-reform-public-policy-alert.pdf>

The SEC's Perspective on Risk Oversight

*"Given the role that risk and the adequacy of risk oversight have played in the recent market crisis, we believe it is important for investors to understand the board's or board committee's role in this area....Such disclosure might address questions such as whether the persons who oversee risk management report directly to the board as a whole, to a committee, such as the audit committee, or to one of the other standing committees of the board and whether and how the board or board committee monitors risk."*⁷

⁷ <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>, page 35

KPMG's Perspective on the Linkage of Risk and Compensation

*"The importance of risk culture can never be underestimated....To reinforce risk culture, the organization's risk appetite should be integrated into the performance management [and compensation] framework at the individual [employee] level to ensure consistent application."*⁹

⁹ KPMG LLP, "Understanding and articulating the risk appetite," 2009, page 8

- Company leadership structure;
- The board's role in the risk management process; and
- Potential conflicts of interest of compensation consultants that advise companies.⁶

Released in July, the proposed rule is subject to a 60-day comment period that ends September 15, 2009. The SEC is expected to issue the final rule in the fall, and it is expected to be applicable to FY2010 proxy and information statements, annual reports, and registration statements.

Forward looking organizations and board members should take steps now to understand proposed legislation. Executives should consider how they and their companies could be affected, and determine how to prepare for new disclosure requirements and related shareholder and investor questions or concerns.

Two important areas will require lead time and thus warrant special focus:

Alignment of Compensation and Risk

If the proposed rule is adopted, companies will need to include in their Compensation Discussion and Analysis (CD&A) details of their broad compensation policies and how they impact risk taking. This means that compensation policies would have to be considered within the context of the organization's risk profile, i.e., the prioritization of key enterprise risks that

threaten the organization's strategies, business model, and existence. Considering compensation within the context of the risk profile is a step most organizations and their boards traditionally have not taken.

Such an effort is likely to be complex and time consuming because compensation policies and incentive compensation arrangements, many of which are typically linked to short term goals, must now be evaluated in light of the company's long term well-being, commensurate risk appetite, and risk culture.⁸ An organization's business units may have their own compensation policies and risk profiles as well as their own approaches to risk taking. Without oversight, the business units could be increasing the overall risk of the organization. Capturing and addressing circumstances such as these may not be easy, and careful consideration must be given to the points of view of investors and shareholders, who will now be able to scrutinize disclosures describing such linkages.

Governance and Board Oversight of Risk

The proposed rule would also require companies to disclose the basis for the company's leadership structure (e.g., separation of chairman and CEO) and how risk is monitored, including whether these efforts are the responsibility of the board overall or one of its standing committees. Disclosure of director qualifications is another key provision

⁶ <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>

⁸ Risk culture is typically defined by KPMG professionals as "the system of values and behaviors present throughout an organization that shape risk decisions." Farrell, John Michael and Hoon, Angela. "What's Your Company's Risk Culture?" Directorship.com, April 15, 2009.

of the proposed rule, which also emphasizes the role that risk assessment and management credentials may play in the governance processes. The proposal notes that, "As recent market events have demonstrated, the capacity to assess risk and respond to complex financial and operational challenges can be important attributes for directors of public companies."¹⁰

Moreover, in the wake of the financial crisis, many organizations recognized the shortcomings in their efforts to manage risk. For example, many found that often they had focused on compliance rather than efforts to manage business risks across the enterprise. Partly as a result of the financial crisis and the legislative and regulatory focus on risk, many organizations are augmenting their in-house risk credentials by establishing a role and enhanced reporting structure for a dedicated risk executive to lead the risk management effort.¹¹

One other underlying governance theme in this proposal and in bills pending in Congress is the importance of managing and disclosing conflicts of interest. For example, the SEC's

proposed rule includes requirements that existing directors or nominees disclose membership on public company corporate boards over the past five years as well as the facts and circumstances of the conflicting roles that compensation consultants may fulfill. The bill originating from Congress would require that compensation committee members be independent as defined ultimately by the SEC (see the latest development on page 4). Understanding how conflicts are managed across the enterprise in this new legislative environment, and more important, how corresponding controls to manage conflicts are embedded in the process, is a key focus of the new wave of company risk assessments.

In light of the potential new SEC disclosure rule and other related outstanding legislative proposals, company executives and board members should thoroughly reevaluate existing risk processes with a shareholder and investor lens, focusing on how compensation policies and governance structures are aligned with risk taking and risk oversight.

Seven Questions Executives and Board Members may be Required to Consider

- 1 Has the company's leadership structure (i.e., separating or integrating board chair / CEO) been reviewed to ensure that it is in line with the company's governance principles?
- 2 Have board members' qualifications and credentials, including those related to risk management, been captured and prepared for enhanced disclosure in line with the SEC proposal and other regulatory enhancements?
- 3 How does the board currently oversee the risk management function—both risk content (allocation of key enterprise risks among full board / board committees) and the risk process?
- 4 Has the organization recently evaluated its compensation policies for their impact on risk?
- 5 Does the company have a formalized Enterprise Risk Management (ERM) process in place? Does the company's risk profile and ERM process address compensation derived risks? Management of conflicts?
- 6 Does the organization and board agenda include an impact analysis of the proposed rules and their potential implications for the business?
- 7 Is the board aware of the company's use, if any, of compensation consultants and their influence on compensation policy?

¹⁰ <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>, page 26

¹¹ KPMG LLP, "The Business Case for a Risk Executive: Leading Efforts to Avoid Surprises, Maneuver through Challenges, and Add Value," 2009.

Note: KPMG service offerings related to executive compensation do not include any services related to assisting clients in designing, implementing, or amending compensation or employee benefit plans.



Latest Development: U.S. House of Representatives Approves “Say on Pay” Bill Linking Compensation and Risk

The proposed legislation would require additional disclosures by public companies (with some size related exclusions) concerning compensation practices and related risks, such as:

Shareholder approval of executive compensation and golden parachutes: Boards would be required to hold a separate annual shareholder non-binding vote to approve executive compensation, in keeping with SEC compensation disclosure rules. Proxy disclosures concerning transactions such as acquisitions, mergers, consolidations, or proposed significant asset sales would be required to include information about the transaction-related executive compensation arrangements of the principal executive officers.

Focus on independence: The board’s compensation committee members would be required to be independent (as defined by the SEC) members of the board. Advisors such as compensation consultants as well as legal counsel would also need to meet the SEC’s independence standards.

Enhanced disclosure and reporting of compensation arrangements for certain financial institutions: These financial institutions would be required to disclose to the relevant regulators the structures of the incentive-based compensation arrangements for their officers and employees to demonstrate that these policies are aligned with sound risk management, among other goals. The specific rules are to be developed jointly by the appropriate federal regulators and will elaborate on the details of these provisions; however, incentive arrangements deemed to encourage inappropriate risk taking would be prohibited.