

## **Proxy Disclosure Enhancements and ERM Opportunities**

By Paul L. Walker, William G. Shenkir and Thomas L. Barton

On December 16, 2009, the U.S. Securities and Exchange Commission (SEC) issued Final Rule 33-9089, "Proxy Disclosure Enhancements." It was effective February 28, 2010.

The new rule covers disclosures associated with:

1. The Role of the Board in Risk Oversight
2. Governance and Director Qualifications
3. Compensation Table and Compensation Consultants
4. Accelerated Reporting of Voting Results

Senior financial executives should be aware that although the chief legal counsel may take the primary responsibility for the proxy statement, many other areas (such as the annual report) are affected by the rules and related disclosures. Additionally, financial executives who serve on boards should be especially interested in how this new rule impacts their role in risk oversight and the related disclosures.

The rule was partially fueled by investor demand for more accountability and transparency. It meets this demand by enhancing proxy and annual reports via significantly improved information related to risk, board oversight, directors and nominees, compensation, and voting results.

Although it is a regulatory requirement and compliance is essential, the rule also presents opportunities for company management and boards to strengthen their existing processes in some critical areas, especially the management of significant risks with Enterprise Risk Management (ERM).



## 1. The Role of the Board in Risk Oversight

The bar has been raised once again for directors and board nominees. This is not surprising given the ever-changing view of the relationship between boards and risk, held by regulators, government officials, and the courts. The rule makes two important changes related to the board and risk oversight. Companies are now required to disclose:

- Board leadership structure and the board's role in risk oversight, and
- Risk management and incentives linked to compensation policies and practices.

### Board Leadership Structure and the Board's Role in Risk Oversight

The role of management and boards with respect to risk has continued to evolve since 2001, when Financial Executives Research Foundation published early research in this area (see *Making Enterprise Risk Management Pay Off* by Barton, Shenkir and Walker). That work led to COSO-sponsored research, which led to the development of COSO's Enterprise Risk Management Framework. Even during the debate about the implementation of the Sarbanes-Oxley Act, some were calling for the SEC to go beyond financial reporting and internal controls, and mandate a broader approach to management of all company risks.

Thus, it is not too surprising that some observers wanted the SEC to require disclosure about a company's comprehensive risk management process as opposed to any "stand-alone" disclosures. It is interesting to note that a search on [www.SEC.gov](http://www.SEC.gov) for COSO's "Enterprise Risk Management" framework reveals about 2,800 hits. Of further interest is that the SEC noted that most respondents to the SEC's proposed rule (33-9052, issued July 10, 2009) were supportive of the original proposed rules in this risk oversight area (some of the other areas had heavy opposition):

<http://www.sec.gov/comments/s7-13-09/s71309.shtml>

The SEC's new emphasis on risk oversight is centered on providing meaningful information to investors about corporate governance practices. The final rule requires a discussion of:

- "Whether and why" the principal executive officer and board chairman are one position or two.

This should include a "whether and why" discussion if the company utilizes a lead independent director and a discussion of that person's specific role. The idea here is transparency, not to force a company to choose one approach or the other.

With respect to risk oversight, the new rule requires:

- A description of the board's role in risk oversight.

The SEC stated that risk oversight is a “key competence” of the board and this disclosure will improve the understanding of how the board is involved in risk management through oversight. Of particular note, the SEC felt it important that shareholders understand the relationship between management and the board when it comes to risk management.

For companies possessing an existing Enterprise Risk Management (ERM) framework, this new disclosure should be straightforward. However, the SEC did not settle the debate about whether audit committees or risk committees should assume the role for risk management. That is left for companies and their boards to decide. The SEC also suggested that companies “may” want to address the reporting structure for individuals who oversee risk management. That is, does the risk manager or chief risk officer report to management or a board committee? Finally, the SEC noted that risk oversight disclosures also apply to registered funds. With regard to these new rules, SEC Chairman Mary Shapiro told those that advise corporate clients to “counsel your clients to live within the spirit of these rules – to encourage greater disclosure, not less.”

**Opportunities.** The topic of risk management, especially ERM, is garnering much attention in the wake of the recent financial crisis. The new SEC directives offer companies opportunities to examine their own risk management policies and practices in productive ways. In achieving SEC compliance, companies should consider the following actions:

- Start, at a minimum, an effort to identify risks, to assess risks, and to create board level reporting for all major risks.
- Determine who should have risk oversight at the company and at the board. Many companies assume the audit committee should own the board responsibility but that may not be the best alternative.
- Establish a separate risk committee.
- Improve communication between board committees. Under the current environment, it is possible that each committee knows some risks but does not see the big picture. Boards need to connect the risk dots.
- Update the charter of the committee(s) that takes responsibility for risk. Many companies currently only have vague policies on risk and frequently the policies only refer to internal control related risks. This is not the same perception of risk that the SEC is pursuing in this rule. The SEC’s approach is much broader, approaching the level of enterprise-wide risk.
- Draft a risk charter, philosophy and vision statement, if they do not already exist.
- Disclose more than the minimum (as SEC Chairman Shapiro suggested). Take a look at the 2,800 hits already disclosed on [www.SEC.gov](http://www.SEC.gov). There are many excellent examples available there and internationally, where other countries have already mandated risk oversight disclosures.

- Link any new risk oversight efforts to similar pushes for greater risk management and oversight by the NYSE listing requirements, reviews done by Standard and Poor's, and board fiduciary changes being suggested in the courts.
- Use the opportunity to think beyond what the SEC is requiring. For example, if a major risk is due to a receivable having potential collectibility issues, the accounting and finance view would be to purchase a credit default swap (short-term risk management) and later diversify the risk (longer-term risk management). Consider, however, that the larger and more immediate risk may not be client bankruptcy, making collection impossible, but how the loss of the client impacts operations, distribution channels, level of employees, continued cash flows, etc.
- Implement an abbreviated ERM system that is tailored to board oversight. This abbreviated ERM can be expanded later as the company determines. Update the abbreviated ERM effort quarterly.
- Develop risk dashboards for the major risks. A risk dashboard -- which might be as simple as one page -- can provide a concise overview of major risks, pinpointing problem areas quickly. As an analogy, the fuel gauge on an automobile dashboard will signal when it is time to fill the tank.
- Foster an image as a "best risk practices" company through enhanced disclosures.
- Implement a full company-wide ERM process.

## Risk Management and Incentives Linked to Compensation Policies and Practices

The second change related to risk and oversight focuses on compensation. The SEC stated its belief that compensation incentives can lead to excessive risk taking by employees. Most companies would probably agree with this observation, but they would also recognize that companies grow and make money by taking risks (as opposed to sitting on cash). The SEC acknowledged that the linkage between compensation and risk taking may not be completely understood.

The new SEC rule requires:

“A discussion of the company’s compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company’s risk and management of that risk...”

Some key aspects related to this disclosure are as follows:

- The final rule covers all employees, not only executives, if the “practices create risks that are reasonably likely to have a material adverse effect on the company.”
- Note the “reasonably likely” threshold in the rule. This is the same MD&A threshold requiring “risk-oriented” disclosure of material trends and uncertainties.
- Mitigating controls can reduce the risk to below the threshold.
- Finally, the disclosure only covers material adverse risks.

The SEC noted the following items could trigger the compensation disclosure:

- A business unit (BU) with a significant portion of the company’s overall risk profile.
- A BU with a significantly different compensation structure than other BUs.
- A BU with significantly more profits than other BUs.
- A BU with a higher ratio of compensation expense to revenue than other BUs.
- Policies that differ from the risk and reward structure of the company. For example, task specific bonuses are paid where the company retains the long-term risk.

The SEC has stated it does not expect boilerplate disclosure, so registrants should carefully construct these disclosures. For example, generic language such as, “The company’s incentive plans are designed to attract top talent in our field” would not only be insufficient but could even raise a flag.

In addition, smaller reporting companies are not required to provide this disclosure because the SEC believes that smaller companies are “less likely” to have these types of compensation policies and practices. Nor does the SEC expect companies to make “affirmative” statements that nothing significant was found.

It is not hard to recall the stories of Nick Leeson at Barings Bank, Joseph Jett at Kidder Peabody and AIG's credit default swap unit, and see the rationale behind this rule. However, identifying these risks may not be as easy as comparing BU profits or ratios. In comments on this new rule, SEC Chairman Shapiro stated, "We expect that companies will carefully examine their own practices. This in turn should enable companies and their boards to more appropriately calibrate risks and rewards."

**Opportunities.** Once again, the SEC rule provides opportunities for companies to strengthen their own mechanisms for managing risks. Companies should consider these possibilities:

- Develop a risk analysis or risk map by BU. Some companies have been doing this already for quite some time (see *Enterprise Risk Management: Pulling it All Together*, Walker, Shenkir and Barton, 2002).
- Look at the history of each BU to see how much variation is in the revenues, expenses and profits. Use this only as a guide because the past does not always predict the future.
- For each BU, consider how the compensation policies alter the budget, financial statements and risk maps.
- Take the time to compare BUs on the dimensions of
  - Risk profile using maps and analysis above,
  - Compensation structure,
  - Profitability, and
  - Compensation expense as a percentage of revenue.
- For each BU's new budget, require an analysis of how the compensation policies are linked to the budget and an explicit identification of any changes in these policies since the last budget.
- If the analysis says the material effect is only upside, think again. That should be a rare situation.
- Consider hiring external consultants to assist in this process. It is doubtful that AIG actually saw the full downside potential of its material risks. Management was possibly too close to the situation or too biased. External consultants may have a better and more accurate perspective. Since the SEC (see discussion below) has stated its concern about certain conflicts of interests regarding compensation consultants, companies should be careful in using the same consultants to assess the risks of contracts for which they were the primary consultants.
- Using the above approaches, develop a list of all potential risks related to compensation policies and practices.
- Document the mitigating controls surrounding each identified material risk. Consult with the internal auditors or external auditors to gain their perspective on these mitigating controls. Furthermore, factor in SEC SAB's 99 and 108 (on materiality) when making this decision.
- Determine the likelihood of each assessed risk having an adverse effect. To assist in determining likelihood, consider how often the event has happened in the past. An additional consideration should be the time frame for which likelihood is being determined (next three months, next 12 months, etc.).

## 2. Governance and Director Qualifications

There are new disclosures covering director and board nominee qualifications and past directorships. In addition, the rule extends the period of time for disclosing pertinent legal actions involving executive officers and directors. As in the previous requirements, the SEC believes these changes provide meaningful information to investors.

The SEC eliminated a proposed disclosure of “risk assessment” skills of directors but as can be seen from the entire document, these skills are important. It appears the SEC decided not to single out “risk assessment” skills as opposed to other skills (as some respondents had suggested).

The first new disclosure is each director’s or board nominee’s particular skills, qualifications, and experience used in the process by which they were selected to be candidates for the board. This disclosure also covers directors not up for reelection. The rule does not affect minimum qualification disclosures already made elsewhere. Also the rule does not require disclosure of a particular skill for committee work unless that skill was used to choose the director for a particular committee, such as the audit committee.

The second new required disclosure covers any other directorships at public companies and registered investment companies held by each director and nominee within the last five years. The idea behind this disclosure is to allow shareholders to evaluate director experience and potential conflicts of interest.

The third new disclosure extends the time for disclosure of legal proceedings from five to 10 years, and it covers all directors, board nominees, and executive officers. There are also additional disclosures related to the type of legal proceedings, such as judicial proceedings, stock exchange disciplinary actions, etc.

The rule also requires disclosure about how a nominating committee considers diversity as well as disclosures on any related diversity policies for directors. This concept of diversity is self-defined and could cover race, gender or even professional experience. Respondents to the proposed rule reacted favorably to this requirement. There is some empirical evidence that board diversity improves a company’s financial performance.

### 3. Compensation Tables and Compensation Consultants

There are new disclosures related to compensation tables and consultants. The first is in the area of stock and option awards, and requires:

“Reporting of the aggregate grant date fair value of stock awards and option awards granted in the fiscal year in the Summary Compensation Table and Director Compensation Table to be computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation— Stock Compensation (‘FASB ASC Topic 718’), rather than the dollar amount recognized for financial statement purposes for the fiscal year, with a special instruction for awards subject to performance conditions.”

The SEC believes the aggregate award compensation amount (grant date fair value) to be more informative disclosure than the financial statement impact number, which is the result of an allocation of the aggregate amount to time periods. Furthermore, this disclosure should better reflect compensation committee decisions and that should be useful to investors. This is an important disclosure because, as the SEC states, it influences “the calculation of total compensation, including for purposes of determining who is a named executive officer.” The SEC also has special instructions for awards subject to performance conditions and allows for a transition period.

The second new disclosure addresses fees paid to compensation consultants. The SEC expressed concern over fees paid to compensation consultants who might earn fees in several areas unrelated to executive compensation and potentially create a conflict of interest. Transparency is a critical issue here. The final rules are summarized as follows:

- Fee disclosure is required if the board’s compensation consultant provides other services that exceed \$120,000.
- Companies are required to disclose whether these non-executive compensation consulting contracts were recommended by management and approved by the board.
- Fee disclosure is also required if the Board does not have a consultant, but the company receives executive compensation consulting services and the fees for non-executive compensation consulting are above the \$120,000 threshold.
- Fee disclosure is not required if both management and the board have their own (different) compensation consultants.
- Other services, such as statistical or non-discriminatory compensation services, are not treated as executive compensation consulting for these disclosure rules.



#### **4. Accelerated Reporting of Voting Results**

It is now required that shareholder voting results be disclosed on Form 8-K, as opposed to Forms 10-K and 10-Q. In addition to the form change, the deadline to disclose the results is now four business days after the end of the meeting in which the voting occurred. The SEC stated that in some cases, such as contested elections, the four day window will necessitate disclosing preliminary results first and then issuing an amended report within four business days after final voting results are known. The SEC noted that before this rule, the reporting of voting results sometimes took months. The SEC believes the timeliness of this rule is an important element that should benefit many interested parties.

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In light of the recent financial crisis, improvements in risk management are imperative. The SEC's Rule 33-9089, while heavily compliance-oriented, offers companies an opportunity to review and bolster their risk management and risk oversight procedures; as well as engage in meaningful dialogue and analysis in other critical areas, such as compensation. The SEC rule need not be viewed as a burden but as an opportunity.

## About the Authors

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Professor Walker was one of the original consultants to COSO on their enterprise risk management process and framework and has served as an advisor to both small and large organizations on enterprise risk management (including the Federal Reserve Bank, several Fortune 500 companies, a leading university, and international companies). Additionally, he has been invited to train international audiences on ERM, including companies with operations in South Korea, Japan, and Belgium.

Professor Walker has visited the headquarters of some major companies (e.g., Wal-Mart, Microsoft, and DuPont) to study their ERM processes. Professor Walker has co-authored numerous manuscripts on enterprise risk management including the books ***Making Enterprise Risk Management Pay Off*** (FERF) and *Enterprise Risk Management: Pulling it All Together*.

Shenkir, Barton and Walker are principals of ERM Associates. For more information on ERM, visit [www.ermassociates.net](http://www.ermassociates.net) or email [info@ermassociates.net](mailto:info@ermassociates.net) .”

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