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SEC Proposes Enhanced Compensation and Corporate Governance Disclosures

By Vincent A. Vietti and Lauren W. Taylor

On July 9, 2009, the Securities and Exchange Commission (SEC) issued a proposal to revise and enhance the disclosure requirements relating to executive compensation and other corporate governance matters. The proposed rules are designed to provide increased disclosure and transparency regarding:

- Executive officer compensation;
- How overall compensation policies, including those for non-executive officers, affect an issuer's risk profile;
- Corporate governance structure;
- Qualification and background of directors and officers;
- Use of compensation consultants; and
- Prompt disclosure of results of shareholder votes.

The proposal, which is summarized more fully below, appears driven by SEC response to investor concerns for broader and more meaningful disclosure in these areas. The comment period expires September 15, 2009, and if adopted, the rules would be applicable to the 2010 proxy season.

Compensation Disclosure

To address concerns that compensation policies may have become disconnected from long-term financial goals and that incentive compensation policies applicable to non-executives may be important to this assessment, the SEC has proposed additional disclosure to the Compensation Discussion and Analysis (CD&A) required under S-K Item 402. Specifically, issuers will be required to discuss how their overall compensation policies for employees in general, including non-executive officers, create incentives that can affect such issuer's risk profile and management of that risk, if the risks arising from those policies and practices have a material effect on the issuer. For example, situations that may require disclosure could include compensation policies and practices at business units that are significantly more profitable than others in the company; compensation policies and practices at a business unit that carries a significant portion of the company's risk profile; or compensation policies and practices at a business unit with compensation structured in a significantly different manner than other units. The SEC believes that analysis of broader compensation policies may be appropriate because such policies may create risks that may not be otherwise apparent from a discussion focused solely on executive compensation.

Smaller reporting companies are not currently required to provide CD&A. Although the proposal does not require them to provide CD&A or the enhanced disclosure, the SEC has solicited comment on whether such issuers should discuss their overall compensation policies as they relate to risk management.

Compensation Tables. The proposal also seeks to amend the summary compensation and director compensation tables by requiring companies to report as compensation the aggregate grant date fair value (computed in accordance with FAS 123R) of equity-based awards issued during the fiscal year to named executive officers (NEO) and directors. Currently, issuers are required to report compensation based on the dollar amount recognized for financial statement reporting purposes for that fiscal year. Readers may recall that the 2006 amendments to the executive compensation disclosure originally required that the grant date fair value rather than the amount recognized for financial reporting purposes be reported. The SEC has concluded that grant date fair value provides more meaningful disclosure to investors because it:

- Allows investors to better evaluate the amount of equity compensation awarded in a given year;
- Is more indicative of which executives the issuer intends to compensate most highly;
- Avoids any possibility of "negative compensation" being disclosed; and
- better reflects the compensation decision.

This proposal will be of particular interest to smaller reporting companies as current rules do not require these issuers to disclose the grant date fair value of equity awards. If the proposal is adopted, they will be required for the first time to disclose the grant date fair value of equity awards in their compensation tables.

In addition, issuers would no longer be required to report the amount of salary or bonus forgone at the NEO's election in the salary and bonus columns of summary compensation table. Rather, the non-cash awards received would be reportable in the column applicable to the form of award elected. The summary compensation table would then reflect the form of compensation ultimately received by the NEO.

Use of Compensation Consultants. Investors have raised concerns regarding ancillary services by compensation consultants. In response, the SEC is proposing additional disclosure if a compensation consultant plays a role in determining or recommending the amount or form of executive or director compensation and such consultant or any of its affiliates perform additional services for the company. This includes:

- A description of the nature and extent of the additional services;
- The fees for the executive or director compensation engagement and the aggregate fees for all the additional services;
- Whether the decision to engage the consultant for the additional services was made or recommended by management; and
- Whether the additional engagement had been approved by the compensation committee or the board.

Director and Nominee Disclosure

The SEC's proposed rules would also expand the current narrative disclosure requirements regarding directors and nominees. Specifically, issuers would be required to disclose the following for each director and nominee:

- The specific experience, qualifications or skills that qualify the individual to serve as a board or committee member.
- The directorships held at public companies by the individual at any time during the past five years. (The current rule requires disclosure of only current directorships.)
- Certain legal proceedings that occurred in the past 10 years involving each director or nominee. (The current rule requires disclosure of certain legal proceedings for only the past five years.)

The enhanced requirements are designed to provide investors with the ability to better evaluate why a particular person is qualified to serve on the board and whether any past board memberships or relationships pose a conflict of interest. The SEC is seeking comment regarding, among other things, expanding the categories of legal proceedings that must be disclosed, whether disclosure of such legal proceedings should be mandatory even if not material, and whether any special accommodations should be made for smaller reporting companies.

Governance Disclosure

The proposed rules would also require issuers to discuss their leadership structure and why they believe it is the best structure for the company. This rule is intended to elicit information about why a company has chosen to separate or combine the positions of chief executive officer and board chairman and whether it has a lead independent director. The proposed rules require additional disclosure regarding "how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company." This rule is intended to elicit information about whether the board implements and manages its risk management function through the board as a whole or through a committee, such as the audit committee; whether the persons who oversee risk management report directly to the full board or to a standing committee of the board; and whether and how the board, or board committee, monitors risk.

Prompt Disclosure of Voting Results

Finally, the proposed rules would accelerate the disclosure of voting results of annual or special meetings by requiring issuers to disclose voting results of any matter submitted to shareholders on a Form 8-K within four business days after the end of the

meeting at which the vote was held. If the vote relates to a contested election of directors and the voting results are not definitively determined at the end of the meeting, the company would be required to disclose the preliminary voting results on a Form 8-K within four business days after the preliminary voting results are determined. The company would then file an amended Form 8-K within four business days after certification of the final voting results.

SEC Approves Amendments to NYSE Rule 452 Eliminating Discretionary Voting by Brokers in Uncontested Director Elections

By Vincent A. Vietti and Lauren W. Taylor

On July 1, 2009, the Securities and Exchange Commission (SEC) approved an amendment to New York Stock Exchange (NYSE) Rule 452 that eliminates discretionary voting by brokers in uncontested director elections. The amendment makes uncontested director elections (i.e., elections where no other party proposes nominees in opposition to the management nominees) "non-routine" matters. As a result, brokers will be prohibited from casting votes without instructions from beneficial owners. The rule change will be effective for shareholder meetings held on or after January 1, 2010.

Because NYSE Rule 452 applies to all brokers that are members of the NYSE, this change will affect virtually all public companies, not just NYSE-listed companies. The implications and potential impact of this amendment, discussed below, will be significant, particularly for companies that have a large number of retail shareholders (i.e., individual investors).

The Amendment

Rule 452 allows brokers to vote on "routine" items if the beneficial owner of the shares has not provided specific voting instructions to the broker at least 10 days before a scheduled meeting. The Rule prohibits brokers from exercising discretionary voting power in matters that are considered "non-routine"—generally, contested matters and matters that may substantially affect the rights and privileges of shareholders.

Before the amendment, uncontested director elections had been considered "routine" matters, and brokers could exercise their discretion to vote uninstructed shares in such elections, which they typically did in favor of the management nominees. Beginning in 2010, uncontested director elections will be considered "non-routine" matters (except in the case of investment companies registered under the Investment Company 1940 Act that were specifically excluded by the amendments), and brokers will be prohibited from voting uninstructed shares.

Impact of the Revised Rule

Amended Rule 452 is expected to have a material impact on all public companies, including the following:

Majority Voting Standard. Companies that have adopted or are considering the adoption of a majority voting standard in director elections should consider the potential impact of the amended NYSE Rule 452. The inability of brokers to vote uninstructed shares will likely result in fewer shareholder votes in uncontested elections. Because fewer votes will be cast, companies could find it more difficult to achieve the affirmative vote required for the election of management nominees.

Establishing a Quorum. The amendment may also make it more difficult to establish a quorum for the conduct of business at annual meetings. Historically, brokers have helped companies to achieve a quorum because broker votes are counted for quorum purposes even with respect to "non-routine" matters on which they are not entitled to vote so long as there is at least one routine item to be voted upon at the meeting. As a result, issuers may face problems achieving a quorum at meetings at which only the election of directors and other non-routine items are on the agenda. This could be particularly troublesome for issuers with a large number of retail shareholders. Companies may want to consider, if appropriate, including in the agenda for their annual meetings a matter that remains "routine" under amended Rule 452 (such as ratification of independent accountants) in order to ensure that the necessary quorum is obtained.

Increased Influence of Institutional Shareholders, Proxy Advisory Firms, and Activist Shareholders. Available data suggests that most uninstructed shares are held by retail shareholders who do not provide voting instructions to their brokers. One effect of amended Rule 452 may be to decrease the number of votes by retail shareholders and proportionally increase the number of votes by institutional shareholders, giving institutional shareholders more influence over the election of directors. This potential increase in institutional

shareholder voting power could increase the effectiveness of "withhold the vote" or "vote no" campaigns against directors by shareholder activists and proxy advisory firms.

Consideration of E-Proxy Rules. The SEC's e-proxy rules permit companies to provide shareholders access to proxy materials online rather than by printing and delivering hard copies. Companies using this "notice-only" option have experienced a significant drop in participation by retail shareholders. The elimination of discretionary broker voting in uncontested director elections could accelerate this decreased participation by retail shareholders as they are less likely to provide voting instructions to their brokers than institutional shareholders. Companies with a high proportion of retail shareholders should, therefore, consider whether it makes sense to adopt or continue to use the "notice-only" option of the SEC's e-proxy rules, especially if the participation of retail shareholders is important to the election.

Increased Costs. As a result of the forgoing, amended Rule 452 may force companies to incur additional costs to solicit shareholder votes in order to establish a quorum, achieve a majority vote, defend against "vote no" campaigns, and to print and distribute proxy materials. Issuers may also need to spend additional time and resources to educate retail shareholders regarding the procedure and importance of directing their brokers to vote their shares.

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