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Client Alert

SEC Modifies Broker Voting Rules and Proposes New Rules Regarding Executive Compensation Disclosures and Corporate Governance

The Securities and Exchange Commission (the "SEC") recently took actions that may have a significant impact on public companies. First, the SEC approved changes to the rules regarding discretionary broker voting that may substantially affect the director election process. Second, the SEC proposed rules that, if adopted, will require public companies to substantially expand disclosures regarding compensation practices and corporate governance.

Elimination of Broker Discretionary Voting for Director Elections in NYSE-Listed Companies

On July 1, 2009, the SEC approved a proposal by the New York Stock Exchange (the "NYSE") to revise NYSE Rule 452 to eliminate broker discretionary voting in director elections. The proposal, which had been pending before the SEC for three years, means that brokers affiliated with NYSE member organizations can no longer vote in the election of directors without instructions from their clients. This rule change affects nearly all public companies, not just NYSE-listed companies, because Rule 452 applies to all brokers that are NYSE members. The rule change applies to shareholder meetings held on or after January 1, 2010.

There are several potential consequences of this rule, particularly for companies with a large retail shareholder base. Retail shareholders often do not vote unless they are actively solicited, a trend that generally has been exacerbated by the shift to the notice and access model of the SEC's recent E-Proxy rules. For companies with majority voting requirements for director elections, the rule change means that it may become more difficult to elect directors. Conversely, the rule change also will have the effect of increasing the influence of institutional shareholders, hedge funds and activist shareholders on the director election process.

It is important to consider that the elimination of discretionary broker voting for director elections also impacts whether a quorum exists for meetings. In most cases this should not be a concern, so long as the company presents proposals for shareholder vote other than director

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elections. For example, many companies ask shareholders to ratify the appointment of independent auditors, for which brokers can still use their discretion to vote, and these broker votes can count towards a quorum for the meeting. However, public companies that do not include such routine items for approval at their annual meeting might have difficulty in meeting the quorum requirements without the broker votes, and may find they need to incur additional proxy solicitation costs to round up enough votes for a quorum.

Proposed Executive Compensation Disclosure and Corporate Governance Changes

On July 10, 2009, the SEC published proposed changes to its rules regarding executive compensation disclosure and corporate governance that, if adopted, could substantially increase the disclosure burden on public companies. The compensation related changes include:

- *Relationship of Compensation of All Employees to Risk.* The SEC has proposed that a new section of the Compensation Discussion & Analysis ("CD&A") be added that would discuss how a company's compensation policies affect risk and risk management. Unlike the rest of the CD&A and the other compensation disclosures in a company's proxy statement, this new section would not be limited to the company's Named Executive Officers. Rather, this section would be required to discuss the compensation policies and practices relating to any employees of the company, including employees that are not officers, if the company determines that risks created by those compensation policies and practices are material to the company.

- *Disclosure Regarding Compensation Consultants.* The proposed rules would require enhanced disclosure regarding a company's use of compensation consultants in cases where the consultant provides additional services to a company. Specifically, a company would be required to disclose the nature and extent of all additional services, the aggregate fees paid for those additional services along with the fees paid for compensation consulting services, whether the management of the company influenced the engagement of the compensation consultants, and whether all additional services have been approved by the company's compensation committee. The SEC noted that the purpose of these amendments is to allow investors to determine whether any additional services performed by compensation consultants create a conflict of interest that affects the objectivity of the consultant's compensation recommendations.

- *Method of Valuation of Equity Awards.* Under the proposed rules, companies would be required to report equity-based awards in the compensation tables based on their grant-date fair value, rather than the amount reported in the financial statements. The SEC indicated that companies generally use the grant-date fair value of an equity award when making compensation decisions, not the financial statement value. As a result, the SEC believes that investors would find the grant-date fair value a more useful measure of the level of compensation the company intended to provide the executive officers. In addition, because the values assigned to equity-based compensation become part of an executive's total compensation, and total compensation is the measure that determines which executives are named executive officers for whom compensation disclosure is required, the SEC believed that using the grant-date fair value would produce a list of named executive officers that better reflects the company's compensation decisions.

The proposed governance related changes include:

- *Company Leadership Disclosure.* The proposed rules would require enhanced disclosure regarding the company's leadership structure, particularly in the situation where the company has a combined chief executive officer and chairman. In that case, the company would have to disclose why the company has combined those positions. Companies would also be required to disclose whether a lead independent director has been designated to lead meetings of the independent directors, and the specific role any lead independent director plays in the company's leadership.

- *Director and Nominee Qualifications.* Additional disclosure about the qualifications and experience of directors and director nominees would be required under the proposed rules. Rather than the brief biography currently required, the proposals would require a discussion of the specific experience, qualifications and skills that qualify the individual to be a director, and a discussion of why the individual's service as a director would benefit the company. Directors and director nominees would also be required to disclose all public company directorships they have held at any time within the past five years, as opposed to only disclosing current public company directorships as required by the current rules. Any legal proceedings involving a director within the past 10 years would also require disclosure, which is increased from the current five year time period.

- *Risk Management Process*. Under the proposed rules, a company would be required to disclose additional information about the board's involvement in the company's risk management process in its proxy statements. The SEC suggests that such disclosure could include a description of whether the board implements and manages its risk through the board as a whole or through a designated committee, and the process by which risk is monitored.

- *Reporting of Voting Results on Form 8-K*. The SEC's proposals would amend Form 8-K to add a new Item 5.07 that would require disclosure of the results of a shareholder vote within four business days after the date of the meeting at which the vote was held. If definitive vote results are not available within four business days, companies would be required to disclose preliminary results within four business days, and amend the Form 8-K within four business days of the certification of the final results. If the proposal is adopted, vote total disclosure would no longer be required in a company's Form 10-Q or 10-K, as required under the current rules.

If the proposed rules described above are adopted, the SEC expects that they would be effective beginning with the 2010 proxy season.

Special thanks to Mikal Shaikh, contributing writer.

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While every effort has been made to ensure the accuracy of this memorandum, it is not intended to provide legal advice as individual situations will differ and should be discussed with an expert and/or lawyer. For specific technical or legal advice on the information provided and related topics, please contact Gerald Roach at 919.821.6668, Amy Batten at 919.821.6677, or Margaret Rosenfeld at 919.821.6714.

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