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# Summary of SEC Final Rule Updates From 2009 That Impact the 2010 Proxy Season

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In the past year, the Securities and Exchange Commission ("SEC") has placed an emphasis on holding company boards accountable to shareholders. Changes to proxy disclosure rules are intended to provide greater transparency for shareholders so that they are better able to evaluate the leadership of public companies. The elimination of the ability of brokers to exercise discretionary voting in uncontested director elections is designed to encourage companies to make a better effort to reach out to shareholders and for shareholders to take a more active role in the election of directors. A proposal granting shareholders greater access to proxies reflects the SEC's desire to place a larger focus on boards of directors, especially in the areas of executive compensation and risk management. Finally, after several extensions, the SEC announced that the smallest public companies and their independent auditors will be required to report to the public on the effectiveness of the company's internal controls starting in June 2010. This memorandum will present the changes to proxy rules and required disclosures resulting from the amended regulations.

## I. Current Action Required

### A. Enhanced Disclosure of Risk, Compensation and Corporate Governance

On December 16th the SEC approved amendments to the rules governing executive compensation and corporate governance to enhance the disclosures companies are required to include in their proxy statements[1]. The new rules will become effective on February 28, 2010.

The new rules require disclosures in proxy and information statements regarding:

- **Compensation Policies.** The rules require a company to address its compensation policies and practices for all employees, including non-executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. Smaller reporting companies will not be required to provide the new disclosure. The disclosure requirements will be listed in Item 402(s) of Regulation S-K.
- **Director Qualifications.** The rules amend Item 401 of Regulation S-K to expand the disclosure requirements regarding the qualifications of directors and nominees, past directorships held by directors and nominees, and the time period for disclosure of legal proceedings involving directors, nominees and executive officers. The final rules require companies to disclose for each director, and any nominee for director, the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director for the company. The rules also require disclosure of any directorships at public companies held by a director or nominee within the past five years. Finally, the amendments lengthen the time during which disclosure of legal proceedings involving directors, nominees, and executive officers is required from five to ten years.
- **Board Diversity.** The SEC approved amendments to Item 407(c) of Regulation S-K requiring disclosure of whether, and if so how, a nominating committee considers diversity in identifying

nominees for director[2]. If the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, the company must disclose how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy.

- **Leadership Structure and Risk Oversight.** Under the amendments to Item 407 of Regulation S-K and Item 7 of Schedule 14A, a company is required to disclose whether and why it has chosen to combine or separate the principal executive officer and board chairman positions, and the reasons why the company believes that this board leadership structure is the most appropriate structure for the company at the time of the filing. Where a company has a lead independent director, the company must disclose why the company has a lead independent director, as well as the specific role the independent director plays in the leadership of the company. Finally, the rules require companies to describe the board's role in risk oversight.
- **Equity Compensation Value.** The SEC approved revisions to the reporting of stock and option awards in the Summary Compensation Table and the Director of Compensation Table, required by Item 402 of Regulation S-K. The amended rule requires companies to report the value of options when they are awarded to executives instead of the current requirement to report the annual accounting charge.
- **Potential Conflicts of Interests of Compensation Consultants.** The rules amend Item 407 of Regulation S-K to require companies to disclose fees paid to compensation consultants and their affiliates when they played a role in determining the amount or form of executive and director compensation and they also provided additional services to the company. Fee and related disclosure for consultants that work with management is not required if the board has its own consultant.
- **Shareholder Vote Results.** The new rules require disclosure of the results of shareholder votes on a Form 8-K within four business days after a shareholder meeting[3]. The amendments also eliminate the requirement to disclose shareholder voting results on Forms 10-Q and 10-K.

### B. Elimination of Broker Discretionary Voting in Director Elections

On July 1, 2009, the SEC approved the New York Stock Exchange's ("NYSE") amendment to NYSE Rule 452 ("Rule 452"), eliminating the ability of brokers to exercise discretionary voting in uncontested elections[4]. Specifically, this change adds the election of directors to the list of "non-routine" matters on which NYSE member organizations are prohibited from giving a proxy without receiving voting instructions from a beneficial owner. Because this rule applies to brokers who are registered with the NYSE, it will have an impact on all publicly traded companies, no matter what exchange their shares are listed on.

Rule 452 provides, in part, that an NYSE member organization may give a proxy to vote stock on a matter without the beneficial owner's instructions if the broker has transmitted proxy soliciting material to the beneficial owner and the owner does not provide the broker with voting instructions at least ten days prior to the scheduled meeting. Rule 452 also contains a list of specific matters which are considered "non-routine" and which a broker may not give a proxy to vote without the beneficial owner's instructions. Historically, an uncontested election of directors was considered a routine matter, and thus not subject to Rule 452. However, because the uncontested election of directors is considered to be "non-routine," brokers may no longer give a proxy without instructions from the beneficial owner.

These changes to Rule 452 could have a significant impact on issuers in the following areas:

- **Majority Voting.** Companies that have adopted a majority voting standard in its bylaws may find it more difficult for a director standing for election to the board to receive the number of votes necessary for his or her election (or re-election). The inability of brokers to vote uninstructed shares makes it more likely that fewer shareholder votes will be cast in an uncontested election of directors.
- **Higher Costs for Uncontested Elections.** The rule change forces issuers, especially those with a majority voting standard, to be more active in soliciting shareholder votes to achieve a quorum and

to meet the requisite voting threshold. Issuers with a majority voting standard will need to undertake efforts to educate their shareholders that their failure to vote constitutes a "no" vote. These efforts could materially increase the cost of uncontested elections.

- **Increased Influence of Certain Constituencies.** Because Rule 452 prohibits brokers from giving a proxy without instructions from the beneficial owner, it is likely that fewer shares of retail investors will be voted. Subsequently, certain shareholder constituencies, such as institutional investors, will receive relatively greater influence in the determination of uncontested elections. The rule change could also allow activist investors to wield greater power over issuers, especially issuers that have adopted a majority voting standard and that have a large retail investor base. Consequently, the issuer must be more cognizant of the demands of these shareholder constituencies.
- **Establishing a Quorum.** The change in Rule 452 could make it more difficult for an issuer to establish a quorum for the conduct of business at the annual meeting. This result would likely occur where a large number of retail investors fail to give their brokers voting instructions and the ballot fails to contain a routine matter on which the broker may issue a proxy to vote. To combat this outcome, it is recommended that issuers include at least one routine matter in their annual proxy, such as the ratification of the issuer's independent auditor, to ensure that brokers may issue shareholder proxies and that a quorum is established.

### C. Audited Assessment of Internal Controls Over Financial Reporting

The SEC announced on October 2nd that small public companies, those with a public float below $75M, are to begin complying with Section 404(b) of the Sarbanes-Oxley Act ("SOX")[5]. This key provision of SOX requires public companies and their independent auditors to report to the public on the effectiveness of a company's internal controls. In the past, small public companies were given extra time to design, implement and document these internal controls before their auditors were required to attest to the effectiveness of these controls. This extension of time expires with the annual reports of companies with fiscal years ending on or after June 15, 2010.

## Future Action Required

### A. Proposed Rules on Shareholder Proxy Access

Perhaps the most controversial rules proposed by the SEC in 2009 are the proposed proxy access rules[6]. On May 20, 2009, the SEC, in a split 3-2 vote, proposed rules intended to provide shareholders with greater access to corporate proxies. The two rules discussed were (1) New Rule 14a-11 which would allow shareholders to include director nominees in the issuer's proxy materials; and (2) Amended Rule 14a-8(i)(8) which would allow shareholders to require the issuer to include in its proxy materials proposals to amend, or request an amendment to, the issuer's governing documents relating to nomination procedures or the issuer's disclosures related to shareholder nominations. The proposed rules have generated hundreds of public comments, causing the SEC to delay a final decision on the rule changes until 2010.

#### a) New Rule 14a-11 - Proxy Access

New Rule 14a-11 would allow a shareholder or group of shareholders to include their proposed nominees for up to 25 percent of the board in the issuer's proxy statement and on the issuer's proxy card, unless state law or the issuer's governing documents prohibit director nominations in general. In order to include a nominee in an issuer's proxy materials, a shareholder must meet two requirements. The shareholder must (1) own their voting securities for at least one year and (2) meet the minimum holdings requirements of: (i) one percent in a large accelerated filer, or a registered investment company with net assets of $700M or more; (ii) three percent in an accelerated filer, or a registered investment company with net assets of $75M or more and less than $700M; or (iii) five percent in a non-accelerated filer, or a registered investment company with net assets of less than $75M. Additionally, shareholders may aggregate their holdings with

other shareholders to meet the ownership thresholds.

If a shareholder, or group of shareholders, meets the eligibility requirements, the shareholder may nominate the greater of one nominee or the number of nominees that equals 25 percent of the issuer's total directors. Shareholders are not prohibited from nominating directors with whom they have a relationship with, and may even nominate themselves or family members. The nominee must meet certain requirements such as: (1) the nominee's candidacy and board membership must not violate applicable laws; (2) the nominee must satisfy the general objective independence standards of the applicable national securities exchange; and (3) shareholders and their nominees may not have a direct or indirect agreement with the issuer regarding the nomination of the nominee.

Nominating shareholders would be required to file with the SEC and issuer a new Schedule 14N. Schedule 14N would require extensive disclosures relating to the shareholder's ownership of the issuer's securities and future intentions. The issuer would be required to include the shareholder's disclosures in its proxy materials, along with the disclosed information regarding the nominee. Furthermore, under the proposed rule, nominating shareholders or shareholder groups would be held liable for any materially false or misleading statements in information provided by a nominating shareholder or shareholder group to an issuer that is included in the issuer's proxy materials.

**b) Amended Rule 14a-8(i)(8) - Narrowing the Election Exclusion**

Presently, under Rule 14a-8(i)(8), issuers may exclude shareholder proposals that relate to a nomination or election or procedures for nominations or elections. Under Amended Rule 14a-8(i)(8), shareholders would have the opportunity to require the issuer to include in its proxy materials proposals that would amend the company's governing documents relating to nomination procedures or the company's disclosures related to shareholder nominations.. The amendment would require shareholders to have continuously held the lesser of issuer voting securities of at least $2,000 or one percent in market value for a period of at least one year prior to submitting a proposal.

Amended Rule 14a-8(i)(8) would require issuers to wait two proxy seasons before utilizing new procedures or disclosures adopted through a shareholder proposal. The first season would be spent establishing the shareholder director nomination procedure. During the second season, the shareholder's proposed directors would be nominated for election.

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[1] *See* Proxy Disclosure Enhancements, Exchange Act Release Nos. 33-9089; 34-61175; IC-29092; File No. S7-13-09 (December 16, 2009).
[2] The SEC has not defined the term "diversity" stating, "companies may define diversity in various ways, reflecting different perspectives. For instance, some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate. As a result we have not defined diversity in the amendments." *Id.* at 39.
[3] Exchange Act Release No. 33-9089, page 58.
[4] *See* Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors and Codify Two Previously Published Interpretations That Do Not Permit Broker Discretionary Votes for Material Amendments to Investment Advisory Contracts. Release No. 34-59464; File No. SR-NYSE-2006-92 (February 26, 2009).
[5] *See* Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, Release Nos. 33-9072; 34-60813; File No. S7-06-03 (October 2, 2009).

[6] *See* Facilitating Shareholder Director Nominations, Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09 (proposed June 10, 2009).