

To: Our Clients and Friends

December 8, 2009

Preparing for the 2010 Proxy Season

Introduction

As public companies turn their attention to the preparation of their annual reports and proxy materials, we want to highlight several developments for the 2010 season:

- reminder of the elimination of broker discretionary voting authority;
- updates for D&O questionnaires;
- considerations for CD&A disclosures;
- considerations in light of other pending SEC disclosure proposals;
- changes to NYSE corporate governance rules;
- recent updates to RiskMetrics' corporate governance policies; and
- considerations in light of pending Congressional legislative proposals.

Elimination of Broker Discretionary Voting Authority

As announced in our July 2, 2009 client bulletin (available [here](#)), the SEC approved the elimination of broker discretionary voting for shares held in street name in director elections, whether contested or not, effective for elections after January 1, 2010. The NYSE's Rule 452 previously allowed brokers holding shares in street name to vote on behalf of beneficial owners on certain "routine" matters if the broker had not received voting instructions from the beneficial owner at least 10 days before the meeting. Previously, Rule 452 treated uncontested director elections as a "routine" matter. This change will eliminate the ability of all NYSE member firms to exercise discretionary voting authority in director elections at any public company, including companies not listed on the NYSE.

As a result of the rule change, vote "no" or "withhold" campaigns will no longer be "diluted" by a block (often in excess of 20% of votes cast) of broker discretionary votes in favor of management's slate. Companies with majority-voting bylaws or policies may find it more difficult to ensure election of management's slate.

Companies that do not request ratification of independent auditors (which are treated as “routine”) may need to consider proposing another “routine” item or otherwise increasing their proxy solicitation efforts in order to ensure the presence of a quorum.

Director & Officer Questionnaires

Earlier this year, the SEC proposed several changes to expand compensation and corporate governance disclosures in proxy statements, as discussed in our July 17, 2009 client bulletin (available [here](#)). Although the SEC has not yet approved these proposals, which may therefore change, they could become effective in the first quarter of 2010. Accordingly, companies might consider addressing several topics covered the proposed rules in upcoming D&O Questionnaires:

- all directorships held by directors and nominees for director at any time during the past five years at public companies, not just directorships currently held;
- extending the time period for disclosure of prior legal proceedings involving directors, nominees and executive officers from five to ten years; and
- “specific experience, qualifications, attributes or skills” that qualify an individual to serve as director and as a member of any committee in light of the company’s business and structure, including information about risk assessment skills, particular areas of expertise and other relevant qualifications, and extending beyond five years if material.

Note that these topics might be relevant whether or not the SEC approves the proposals. For example, prior legal proceedings might be viewed as material, even if older than five (or ten) years.

Considerations for Compensation & Disclosure Analysis (CD&A)

SEC Staff Comments. Last month the Director of the SEC’s Division of Corporation Finance urged companies to take seriously the SEC’s guidance over the past several years, including the following:

- Provide an explanation of “why” compensation decisions are made, not just a description of the actions taken;
- When disclosing the determination of compensation based on achievement of performance targets, the SEC expects for companies to provide specific disclosure of the targets and the actual achievement level against the targets - unless the company can satisfy the requirements for confidentiality based on competitive harm. The Director stressed that the standard for confidentiality is no less rigorous than that for material contracts.
- If the company omits disclosure of performance targets due to competitive harm, the SEC expects “meaningful” degree of difficulty disclosure; a statement that a target is “challenging” is viewed as insufficient absent more detailed information.
- If a peer group is used for “benchmarking” purposes, the SEC expects to see disclosure of the names of the peers and how they were selected, and where actual amounts or awards fell relative to the benchmark.

The Director indicated that the SEC staff expects better CD&As this year, stating:

“It means that after three years of futures comments, we expect companies and their advisors to understand our rules and apply them thoroughly. So, any company that waits until it receives staff comments to comply with the disclosure requirements should be prepared to amend its filings if it does not materially comply with the rules.”

Additionally, she indicated that if a company has not received SEC staff comments on executive compensation during the past two years, “the chances are very good that we’re planning to do so this year.”

Compensation Policies and Risk-Taking Incentives. In light of the SEC’s pending rule proposals regarding CD&A, companies may want to brief their boards and compensation committees, and take preparatory steps in anticipation of possible new disclosure requirements. As discussed in our July 17, 2009 client bulletin (available [here](#)), the SEC has proposed that CD&As include a broader discussion of compensation policies and arrangements with respect to employees generally, including non-executive officers, and how such practices relate to risk management practices and/or risk-taking incentives.

The SEC noted that some compensation practices, such as incentive compensation arrangements, can encourage management and employees to make decisions that might increase company risk and that such practices may promote short-term interests of management and employees that may not be properly aligned with the long-term interests of the company and its shareholders. The proposed rules provide that disclosure would be required if these risks “may” have a material effect on the company. Accordingly, companies may want to implement procedures to collect the necessary information to brief their boards or committees, and evaluate potential disclosures.

Possible Changes to Other Disclosure Requirements

The pending SEC proposals also address several other topics that would be appropriate for board or management consideration in connection with preparing upcoming proxy statements:

- Potential conflicts of interests of compensation consultants, if they or their affiliates play “[any] role in determining or recommending the amount or form of executive and director compensation,” with disclosure of types of services and amounts of compensation therefor;
- Company leadership structure, and whether and why companies have chosen to combine or separate the principal executive officer and chairman positions;
- The board’s role in the risk management process and its effect on the leadership structure including (1) whether the persons who oversee risk management report directly to the board as a whole or a board committee; and (2) whether and how the board or board committee monitors risk; and
- Reporting of the aggregate grant date fair value of stock and option awards made during the fiscal year computed in accordance with SFAS No. 123R (instead of the dollar amount recognized for financial statement reporting purposes).

When initially proposed, the SEC announced that the proposals were intended for adoption prior to the 2010 proxy season. Although the SEC had been expected to take action last month, it is still possible for the proposal to take effect in the first quarter of 2010. Accordingly, companies may want to implement procedures to collect the necessary information to brief their boards or committees, and evaluate potential disclosures.

Changes to NYSE Corporate Governance Rules

On November 25, 2009, the SEC approved changes to the NYSE corporate governance rules that take effect January 1, 2010. A copy the NYSE announcement to listed companies summarizing the changes is available upon request. The principal changes are:

- the elimination of the categorical standards concept for director independence due to the requirement in Item 407(a)(3) of Reg. S-K to disclose relationships the board considered by specific category or type. However, it is expected that many companies will keep their categorical standards as a useful tool in determining independence;
- requiring the CEO to notify the NYSE promptly if any executive officer becomes aware of any non-compliance with NYSE standards (not just material non-compliance);
- replacing NYSE disclosure requirements with a reference to the applicable provision in Item 407 of Reg. S-K (for example, the compensation committee report required by NYSE Rule 303A.05 is duplicative of Item 407(e)(5) and has been changed to just refer to the Item 407 requirement);
- permitting companies to conduct executive sessions of independent directors instead of non-management sessions, and clarifying that companies must allow all interested parties (not just shareholders) to have a means to contact such group;
- permitting companies to make certain disclosures via their website instead of the proxy statement/annual report, including:
 - contributions to tax-exempt organizations with which directors are affiliated;
 - methods to communicate with the presiding director or non-management/independent directors as a group;
 - simultaneous service by a director on more than three public company audit committees;
 - charters of the three principal standing board committees; and
 - corporate governance guidelines and codes of business conduct & ethics

If disclosure is made via the website, the proxy statement/annual report must so state and provide the website address;

- conforming disclosure requirements for ethics waivers to SEC 8-K requirements (i.e., within four business days); and
- eliminating the requirements (1) to disclose officer certifications in the annual report and (2) to provide hard copies of committee charters, guidelines and ethics codes to shareholders upon request.

2010 Updates to RiskMetrics Corporate Governance Policies

RiskMetrics Group, or “RMG,” recently published updates for 2010 to the policies that govern its proxy voting recommendations for meetings held after February 1, 2010.¹ The influence of RMG varies widely among public companies, depending on the composition of their shareholder bases and the willingness of particular institutional investors to defer to RMG views. However, with the elimination of broker discretionary voting, it is possible that the impact of RMG will increase to some extent.

Among the more significant updates for U.S. companies include the following:

Executive Compensation Matters

RMG announced an integrated policy for evaluating executive compensation relating to (1) pay-for-performance, (2) pay practices and (3) board responsiveness and communication. RMG also published an FAQ regarding its executive pay policies.²

- *Problematic Pay Practices.* RMG intends to use management say-on-pay proposals (MSOP) as the primary means to object to poor pay practices - and perhaps to encourage wider adoption of such proposals among non-TARP companies. However, RMG may also recommend withhold/against votes for compensation committee members if (1) egregious practices are identified or (2) a company previously received a negative recommendation on an MSOP proposal regarding an issue that is still ongoing.

Moreover, since many non-TARP companies do not submit MSOPs to shareholders, RMG will likely continue to focus on compensation committee members (or the full board) or equity plan proposals as the means to object to pay practices.

RMG evaluates pay practices on a case-by-case basis but highlighted the matters set forth in Exhibit A attached hereto.

- *Inappropriate Risk-Taking.* RMG intends to place increased focus on practices that may motivate excessive risk-taking, for example:
 - Guaranteed bonuses;
 - A single performance metric used for short- and long-term plans;
 - Lucrative severance packages;
 - High pay opportunities relative to industry peers;
 - Disproportionate supplemental pensions; or
 - Mega annual equity grants that provide unlimited upside with no downside risk.

Factors that RMG views as potentially mitigating the impact of risky incentives include rigorous claw-back provisions and robust stock ownership/holding guidelines.

¹ RiskMetrics Group U.S. Corporate Governance Policy – 2010 Updates (November 19, 2010), which is available [here](#).

² RiskMetrics Group 2010 Corporate Governance Policy Updates and Process: Frequently Asked Questions on U.S. Compensation (November 19, 2010), which is available [here](#).

- *Pay for Performance Policy.* RMG adjusted its policy to add another factor to its case-by-case evaluation: the consideration of the alignment of CEO total direct compensation (TDC) and total shareholder return (TSR) over a period of at least five years (in addition to current reviews of TSR over one- and three-year periods and most recent year-over-year TDC changes).

In addition, RMG explained that companies must disclose in proxy statements the material terms of any equity grants made at the beginning of the current year, if the company wants RMG to take such grants into account for purposes of conducting its pay-for-performance evaluation.

- *Equity Compensation Plans.* RMG modified certain policies regarding equity-based compensation proposals, including:
 - *Burn Rate.* RMG has adjusted its stock price volatility calculation for December 1, 2009 and future quarterly data downloads to use the 200-day volatility and the 200-day average stock price. It views this adjustment as appropriate due to unusual stock market volatility at the end of 2008 and early 2009.
 - *Corrective Measures.* If RMG recommends withholds on directors or compensation proposals due to a “CEO pay for performance disconnect,” it indicated a company could take prospective actions to address the concern, provided such actions meet specified requirements (on a case-by-case basis) and are publicly disclosed. Similarly, if a company fails to meet the three-year average burn rate policy, the company may publicly disclose its commitment to a prospective three-year average burn rate, subject to certain requirements.
 - *Stock Option Overhang Carve-Out.* RMG may exclude the overhang effect of stock options if companies can demonstrate sustained positive stock performance, where the options have been continuously “in-the-money” for at least six years. Stock price performance is generally evaluated based on 5-year total stockholder return as well as positive year-over-year performance for the past five years. RMG may make exceptions for strong companies temporarily affected by the global recession.

Board and Governance Matters

RMG modified some of the policies relating to issuing negative recommendations against individual directors or the entire board.

- *New Nominee.* A new nominee is now defined as any nominee not previously elected by shareholders and who joined the board after a problematic action in question transpired. As a result, RMG may treat a first-time nominee as an incumbent director who should be accountable for past board decisions. If RMG cannot determine if the nominee joined before or after the problematic action, the nominee will be considered “new” if he or she joined within 12 months prior to the upcoming annual meeting.
- *Voting on Directors for Action on Non-Shareholder Approved Rights Plan.* RMG recommendations will now depend on the term of a rights plan. Companies that adopt long-term plans (term more than 12 months) without shareholder approval will be evaluated either every three years, if the entire board is elected annually, or every year, if the board is classified. RMG will recommend against directors who adopt long-term plans without shareholder approval, and will vote on a case-by-case basis on directors who adopt short-term plans without shareholder approval, taking into account specified factors.

- *Voting on Directors for Egregious Actions.* RMG clarified that it will consider voting against a board, committee members or individual directors due to:
 - Material failures of governance, stewardship or fiduciary responsibilities;
 - Failure to replace management as appropriate; or
 - Egregious actions related to service on other boards that raise substantial doubt about his or her oversight abilities.
- *Classification of Directors.* RMG has modified its director independence classifications, by which it labels directors it does not consider sufficiently independent as “inside directors” or “affiliated outside directors” (in contrast to stock exchange tests). These classifications are used by RMG when evaluating, among other things, whether standing board committees are composed solely of independent directors, which exclude insiders and affiliated outside directors.
 - The materiality test for transactional relationships will be bifurcated, so that NYSE-listed companies will now be subject only to an existing NYSE test of the greater of \$1 million or 2% of the recipient’s gross annual revenues. Nasdaq companies will continue to apply the existing Nasdaq test of the greater of \$200,000 or 5% of the recipient’s gross annual revenues.
 - The only transactional relationships involving a director that will be examined for materiality are the following: if the director or immediate family member has the transactional relationship, or if the director or immediate family member is a partner in, controlling shareholder of, or executive officer of, an organization that has a transactional relationship. As in the past, it is expected that RMG will focus on S-K Items 404 (related person) and 407(a) (independence) disclosures for this purpose.
 - RMG clarified the \$10,000 de minimis threshold for professional services as services that are advisory in nature and which generally involve access to sensitive company information or to strategic decision-making, and typically with a commission- or fee-based payment structure.
- *Board-Related Shareholder Proposals.* RMG will evaluate shareholder proposals that seek a director with particular expertise on a case-by-case basis.
- *Establishment of Board Committees.* RMG will generally vote against shareholder proposals to establish a new board committee, as they are seen as potentially limiting a company’s flexibility to conduct oversight.

Shareholder Rights & Defenses

- *Net Operating Loss (NOL) Protective Amendments and Rights Plans.* RMG announced a new policy to evaluate management proposals to adopt NOL protective amendments (such as stock transfer restrictions) on a case-by-case basis, taking into account (1) the ownership threshold, (2) the value of the NOLs, (3) shareholder protection mechanisms, such as sunset provisions, (4) the company’s existing governance structure, and (5) any other relevant factors. RMG already evaluates NOL rights plans on these bases, but added the fourth item as an additional criteria.
- *Shareholder Ability to Call Special Meetings or Act by Written Consent.* In response to shareholder proposals seeking the ability to call special meetings or act by written consent, some companies have submitted management proposals to provide such rights, subject to specified conditions or limitations. RMG will generally vote against proposals to restrict such rights, and will evaluate proposals to provide such rights, taking into account these factors: (1) shareholders current rights, (2) minimum ownership thresholds to call special meetings (10% preferred) or act by written

consent, (3) the inclusion of exclusionary or prohibitive language; (4) investor ownership structure; and (5) shareholder support of and management's response to previous shareholder proposals.

Capital/Restructuring

- *Common and Preferred Stock Authorization.* RMG will continue to evaluate proposals to increase the number of authorized shares of common or preferred stock on a case-by-case basis. However, it will focus on disclosure of specific reasons for the proposed increase. In addition, it will now also take into account (1) the use of existing shares during the last three years; (2) one- and three-year total shareholder return; and (3) the board's governance structure and practices.

In the case of preferred stock proposals, RMG will continue to recommend against requests for blank check preferred stock unless (1) the company commits not to use the stock for anti-takeover purposes without shareholder approval, (2) the company has existing authorized and outstanding blank check preferred stock, making the addition of more shares moot for anti-takeover purposes; or (3) RMG determines the risks of rejection outweigh the risks of approval.

Corporate Responsibility Proposals

- RMG has adopted updated policies on a variety of issues raised by shareholder proponents, including greenhouse gas emissions, board diversity, environmental, and social and governance compensation-related proposals.

Pending Congressional Legislation

The year 2010 may prove as significant as 2002 for public companies, in light of legislative efforts in Congress. Various bills have been proposed which would address, among a host of other topics, such corporate governance matters as the following:

- Codify proxy access, i.e., the ability of shareholders to use proxy materials to nominate director candidates (earlier this Fall, the SEC confirmed that would not take action on its proxy access proposal in time for the 2010 proxy season (discussed in our June 2009 bulletin, available [here](#)), while it continues to study numerous comment submissions)
- Require say-on-pay votes
- Require majority voting for directors
- Eliminate classified boards of directors
- Require disclosure why the same or different persons serve as chairman and CEO
- Require risk committees for specified types of companies
- Require shareholder votes on golden parachutes
- Mandate compensation committee independence
- Require disclosures on and regulating the independence of compensation committee advisers
- Expand clawbacks of executive incentive payments in the event of restatements.

Other aspects would variously include:

- Registration of hedge fund advisers;
- New reporting requirements with respect to investment funds advised by SEC-registered advisers;
- Creation of a new systemic risk regulator;
- Regulation of all OTC derivatives;
- Harmonization of certain aspects of futures and securities regulation; and
- Creation of a new consumer financial products protection agency.

We are monitoring the legislation and intend to issue a client bulletin reporting on the final bill(s) if enacted.

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Exhibit A

RMG's Lists of Poor Pay Practices

Most Problematic Pay Practices Identified by RMG

- Egregious employment contracts:
 - Contracts containing multi-year guarantees for salary increases, non-performance based bonuses, and equity compensation.
- New CEO with overly generous new-hire package:
 - Excessive “make whole” provisions without sufficient rationale
 - Any of the problematic pay practices listed in this policy
- Abnormally large bonus payouts without justifiable performance linkage or proper disclosure:
 - Includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance
- Egregious pension/SERP (supplemental executive retirement plan) payouts:
 - Inclusion of additional years of service not worked that result in significant benefits provided in new arrangements
 - Inclusion of performance-based equity awards in the pension calculation
- Excessive Perquisites:
 - Perquisites for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft or other inappropriate arrangements
 - Extraordinary relocation benefits (including home buyouts)
- Excessive severance and/or change in control provisions:
 - Change in control payments exceeding 3 times of base salary and bonus
 - Change-in-control payments without loss of job or substantial diminution of job duties (single-triggered)
 - New or materially amended employment or severance agreements that provide for modified single triggers, under which an executive may voluntarily leave for any reason and still receive the change-in-control severance package
 - New or materially amended employment or severance agreements that provide for an excise tax gross-up. Modified gross-ups would be treated in the same manner as full gross-ups
- Tax Reimbursements:
 - Reimbursement of income taxes on certain executive perquisites or other payments (e.g., personal use of corporate aircraft, executive life insurance, bonus, etc; see also excise tax gross-ups above)
- Dividends or dividend equivalents paid on unvested performance shares or units
- Executives using company stock in hedging activities, such as “cashless” collars, forward sales, equity swaps or other similar arrangements.

- Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts).

Other Problematic Pay Practices Identified by RMG

- Excessive severance and/or change in control provisions:
 - Payments upon an executive's termination in connection with performance failure
 - Liberal change in control definition in individual contracts or equity plans which could result in payments to executives without an actual change in control occurring
- Overly generous perquisites, which may include, but are not limited to the following:
 - personal use of corporate aircraft
 - personal security systems maintenance and/or installation
 - car allowances
 - executive life insurance
- Internal pay disparity.
- Excessive differential between CEO total pay and that of next highest-paid named executive officer (NEO)
- Voluntary surrender of underwater options by executive officers:
 - May be viewed as an indirect option repricing/exchange program especially if those cancelled options are returned to the equity plan, as they can be regranted to executive officers at a lower exercise price, and/or the executives subsequently receive unscheduled grants in the future
- Other pay practices deemed problematic but not covered in any of the above categories