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Weil Briefing:
SEC Disclosure and Corporate Governance

July 9, 2009

SEC Approves Rule Eliminating Broker Discretionary Voting for Directors

– **Also Proposes Amendments to Enhance Executive Compensation and Corporate Governance Disclosures and to Clarify Proxy Solicitation Rules**

– ***What You Should Do Now***

On July 1, 2009, the U.S. Securities and Exchange Commission approved and proposed measures that will have far-reaching implications for the director election process and proxy statement disclosures and solicitations. Since these measures are to be effective for the upcoming proxy season, companies should begin preparing now. These SEC actions come on the heels of other proposals that could have further significant impact in the boardroom. In the past two months, the SEC proposed a rule giving "shareholder access" to a company's proxy materials for director elections, and several bills were introduced in Congress that propose legislation on a variety of matters including requiring a shareholder advisory vote on executive compensation (a "say-on-pay") and majority voting in the election of directors.[1]

- At the July 1 meeting, the SEC approved a change to New York Stock Exchange ("NYSE") Rule 452, eliminating broker discretionary voting of uninstructed shares in uncontested director elections (except in the case of investment companies registered under the 1940 Act). The amendment to Rule 452 applies to shareholder meetings held on or after January 1, 2010, and affects public companies whether or not listed on the NYSE. The direct effect of the amendment will be to reduce the number of votes cast in favor of the board's nominees, by preventing brokers who have not received voting instructions from their customers (usually "retail" investors) from exercising a discretionary authority to vote those shares as is currently permitted by Rule 452. As brokers generally vote for the board's nominees, this change is expected to strengthen the influence of institutional investors (and their proxy advisors, *e.g.*, RiskMetrics) and activist shareholders and to magnify the significance of "vote no" campaigns. Companies have a short time-frame to consider how this change will affect them in the upcoming proxy season and the ways in which they can encourage retail investors to vote for their boards' nominees.
- Also at the meeting, the SEC proposed several amendments to its rules, which are intended to:
  - *Enhance corporate governance and executive compensation disclosures.* As discussed below, several proposed changes are significant, and companies should begin evaluating their potential impact on governance processes and proxy statement disclosures.
  - *Clarify the proxy solicitation process.* These proposed changes will be of particular interest to activist shareholders. Among others, the proposals clarify some issues arising from

"rounding out" short slates and from sending unmarked copies of management's proxy card to the company's shareholders.

- *Implement the required say-on-pay shareholder advisory vote* for companies that receive financial assistance under the Troubled Asset Relief Program ("TARP").

Since the SEC's proposing release was not available at the time of the writing of this Briefing (except the proposal relating to TARP companies), the information in this Briefing is based on the SEC's press release and comments made at the SEC's July 1 open meeting.[2]

Adoption of Revised NYSE Rule 452: A Change in the Dynamics of Director Elections

At the request of the NYSE, the SEC approved an amendment to NYSE Rule 452, *Giving Proxies by Member Organizations*, to eliminate broker discretionary voting for uncontested director elections.[3] Because NYSE Rule 452 applies to brokers, the amendment affects not only companies listed on the NYSE but also other public issuers, whether or not listed. The effect of the amendment will be significant, especially for companies that have adopted majority voting for uncontested director elections (or that have "plurality plus" resignation policies). Companies will quickly need to evaluate their shareholder base and voting standards.

Background

NYSE Rule 452 currently allows brokers to vote on "routine" items if the beneficial owner of the stock has not provided specific voting instructions to the broker at least 10 days before a scheduled meeting. Rule 452 lists 18 items that are considered "non-routine," including a contested director election, approval of a stock plan or any matter that may affect substantially the privileges of stockholders. On such "non-routine" matters, brokers are prohibited from voting in the absence of instructions from the beneficial owners.

Uncontested director elections have long been considered routine matters, thus allowing brokers to vote uninstructed shares in such elections. In casting votes on routine matters, brokers have generally voted as recommended by the board of directors (*i.e.*, for the board's nominees).

Potential Consequences of Rule Change

The amendment of NYSE Rule 452, which will make every election of directors a non-routine matter, is likely to have a considerable impact on the dynamics of director elections in uncontested elections.[4]

Majority Voting. An increasing number of companies have recently adopted a majority voting standard in the election of directors, either voluntarily or in response to investor demands.[5] Generally, for a company that has adopted majority voting, a director nominee would need to receive at least a majority of the number of votes cast with respect that director's election in order to be elected to the board of directors. Since brokers generally vote with management, the elimination of discretionary voting in the election of directors by brokers will mean the loss of a significant block of votes "for" nominees proposed by management and will generally make it more difficult for directors to achieve the majority support needed for election.

Power of Institutional Shareholders; Disenfranchisement of Retail Shareholders. Retail voters who do not provide voting instructions to their brokers will no longer have such uninstructed shares voted. Therefore, institutional investors (who do vote) will have more influence over the election of directors, while the retail owners will be effectively disenfranchised to the extent they had believed their brokers would be voting their shares. This could have real impact on smaller issuers and those issuers with a significant number of retail owners.

Influence by Proxy Advisory Firms. Proxy advisory firms have increasingly been issuing "withhold" or "against" vote recommendations in director elections due to their growing scrutiny of corporate governance and executive compensation practices and the failure of companies to satisfy favorably the requirements of such firms' voting guidelines. Since many institutional shareholders are influenced by the recommendations of proxy advisory firms (*e.g.,* RiskMetrics or Glass Lewis), the outcome of director elections may be susceptible to companies adhering to proxy advisory firms' voting policies to an even greater degree, especially in conjunction with a majority voting requirement.

Influence by Activist Shareholders. Activist shareholders with a precise agenda will have an enhanced ability (due to lower voting turnouts) to challenge an incumbent board member by instituting "vote no" campaigns. In addition, Rule 452, together with the recent changes to the Delaware General Corporation Law, which allow for the reimbursement of expenses relating to the solicitation of proxies, and in conjunction with the availability of the SEC's "e-proxy" reforms, could make proxy contests more affordable for activist shareholders.

Increased Costs and Resources; Investor Education. Many shareholders do not have a good understanding of the proxy voting process and the ability or inability of brokers to vote uninstructed shares held in street-name. Therefore, companies may need to spend additional time and resources to reach and educate retail shareholders. Smaller companies whose shareholder base includes a smaller proportion of institutional investors and/or that have greater difficulty in contacting shareholders may face particularly difficult burdens and should consider taking steps now to address communication issues.

Quorum Achievement. Brokers have generally helped companies to achieve a quorum for stockholder meetings because broker votes are counted for quorum purposes even with respect to "non-routine" matters on which they are not entitled to vote as long as there is at least one routine item to be voted upon at the meeting. Companies that have a large number of retail investors may face problems achieving a quorum at meetings with only the election of directors and other non-routine items on the agenda. Including on the agenda the ratification of auditors, which is still considered a routine item under Rule 452, will help ensure that a quorum for the meeting can be achieved.

E-Proxy. Companies that have taken advantage of the "notice-only" option under the SEC's e-proxy rules, which permit companies to direct shareholders to access proxy materials online, have seen a significant drop in participation by retail investors. For such companies, this phenomenon will be reinforced by the elimination of broker discretionary voting for directors.

What You Should Do Now

Public companies should take the following actions in response to the amendment to Rule 452:

- All companies, and especially those with majority voting, should assess the probable impact of the rule change on their annual meeting and election of directors. One simple technique is to prepare *pro forma* director election voting results based on the last annual meeting that had a non-routine matter (*e.g.*, approving a stock plan) and subtracting all of the broker non-votes from the votes cast in favor of the director nominees.
- Companies with a majority voting standard or a "plurality plus" resignation policy should revisit the details of those provisions and thoroughly understand their mechanics and consequences.
- Companies with plurality voting should cautiously evaluate any potential move towards majority voting.
- Assess their voter constituency. Those companies with a significant retail base should consider whether to engage a proxy solicitor for assistance to ensure a better voting turn out.
- Consider ways to ramp up efforts to educate retail investors that brokers will not be voting their shares.
- Companies that do not presently seek shareholder ratification of their independent auditors should consider doing so, especially if they do not have other "routine" matters on the agenda.
- Companies with a significant retail shareholder base should consider whether it makes sense to adopt or continue to use the "notice-only" option of the SEC's e-proxy rules, which may further disenfranchise retail voters.
- Assess takeover defenses, including an advance notice by-law to address shareholder nominations of directors and other business.
- Revise disclosure in the company's proxy statement describing the new treatment and effect of broker non-votes in the election of directors, as required by Item 21 of Schedule 14A.

In addition, companies should watch developments in the area closely and monitor whether new systems are put into place to permit retail voters to provide brokers with the discretion to vote on all matters without specific voting instructions. At its open meeting, the SEC emphasized that more comprehensive proxy reforms of the proxy voting system will be considered in the near future to address issues involving shareholder communication, education and participation.

Effective Date of the Rule 452 Amendment

The amendment will be applicable to proxy voting for shareholder meetings held on or after January 1, 2010. The amendment will not apply to a meeting that was originally scheduled to be held in 2009 but was properly adjourned to date on or after January 1, 2010.

Proposed Expansion of Corporate Governance and Executive Compensation Disclosures

The SEC proposed amendments to broaden disclosure on executive compensation and other corporate governance matters. The changes, if adopted, are intended to be applicable for the 2010 proxy season.

Disclosure Related to Corporate Governance

- *More Details About Directors, Nominees and Executive Officers.* The proposed amendments to Item 401 of Regulation S-K would expand the required disclosures to include for each director and nominee the particular experience, qualifications, attributes or skills that qualify such person to serve as a director of the company and as member of any committee in light of the company's business. Currently the rules only require disclosure of the minimum qualifications that a nominee must meet and brief biographical information. This proposed new disclosure likely will be controversial since it appears to require a justification, in some sense, of the board service of each nominee and continuing director (*i.e.*, why was the person selected as a director?).[6] Nominating committees should keep this in mind during their meetings for the remainder of the year. The SEC is also proposing disclosure of any other directorships held by each director or nominee at any public company during the previous five years, rather than only current directorships. Finally, the proposed amendments would extend from five years to ten years the disclosure of legal proceedings involving directors, director nominees and executive officers. The SEC will also solicit comment on whether to require disclosure of whether diversity is factor in nominating board members.
- *New Information About Leadership Structure and Risk Management.* Item 407 of Regulation S-K and Schedule 14A would be amended to require disclosure about the company's leadership structure and why the company believes it is the best structure for the company. Companies also would have to disclose whether and why they have chosen to combine or separate the CEO and board chair positions, and whether the company has a lead director. The proposed amendments would also require disclosure about the board's role in the company's risk management process and the effect, if any, that this has had on the company's leadership structure. Although the SEC makes no judgment concerning the "right" governance structure, we expect some of these proposed changes to be contentious.
- *Expedited Reporting of Voting Results.* The proposal calls for a new item in Form 8-K requiring disclosure of the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. In contested elections, the final results may be delayed under certain circumstances. Under the current rules, voting results are reported in a Form 10-Q or 10-K.

Disclosure Related to Executive Compensation

- *Broadens Compensation Discussion & Analysis for Material Risks.* Item 402 of Regulation S-K would be amended to broaden the scope of the Compensation Discussion & Analysis ("CD&A") to require discussion and analysis of the company's overall compensation policies or practices for non-executive officers and employees generally, if the risks arising from these policies or practices *may have a material effect on the company*. At the SEC open meeting, an SEC staff member reiterated that disclosure in CD&A is already required concerning risk to

the extent considerations of risk are, or will become, a material part of a company's compensation policies or decisions for named executive officers ("NEOs").

- *Revises Disclosure of Equity Awards.* Disclosure of stock and option awards in the summary compensation table and director compensation table would be revised to require disclosure of the *aggregate grant date fair value* of awards made during the year (still computed in accordance with Statement of Financial Accounting Standards No. 123(R)) rather than the value recognized for that year for financial statement reporting purposes under SFAS 123(R). This change should simplify for companies the determination of the amounts belonging in the tables. However, we also expect it to generate its own set of complications, anomalies and confusion. For example, one criticism of the proposed approach is that it will overstate NEO compensation since the award will be reflected in the summary compensation table at full value even though intended to be earned of a period of years and subject to forfeiture. Therefore, the proposal if adopted will require continued efforts by companies to educate their stockholders and the media about the disclosure.
- *Adds Compensation Consultant Disclosure for Potential Conflicts.* New disclosures would be required about fees paid to and services provided by compensation consultants and their affiliates if they provide consulting services related to director or executive compensation and also provide other services to the company. The proposed amendments would require a description of those additional services, the aggregate fees paid for work related to compensation consulting services, the aggregate fees paid for any additional services, whether the decision to engage such consultant for the other services was recommended or made by management, and whether the board of directors or compensation committee approved the other services.

What You Should Do Now

- Company counsel should review the SEC's proposing release when it is becomes publicly available on the SEC's website.
- Companies should begin to evaluate how the proposed requirements could affect their proxy statement disclosure. While public comments for the amendments are due 60 days after publication of the proposing release in the federal register, the SEC intends that the changes, when adopted, will be applicable for the 2010 proxy season.
- Nominating committees and counsel should consider the qualifications that would need to be disclosed for each of their directors and nominees, as required by the proposed amendment to Item 401 of Regulation S-K.
- Nominating committees and counsel should also be prepared to justify the company's governance structure (particularly a combined CEO-Chairman position) if the proposed disclosure rules are adopted. Many companies have already confronted this issue in response to shareholders' Rule 14a-8 proposals.
- Compensation committees and management should revisit compensation policies (for all employees) in order to determine whether such policies are creating an incentive for risk-taking that may have a material effect on the company.
- Companies should consider creating a *pro forma* summary compensation table that reflects the proposed method of valuing equity awards as a "trial run."

Proposed Clarifications of Proxy Solicitations: Activist Shareholders Take Note

The SEC proposed several changes in the way management and shareholders communicate or seek authority in the proxy solicitation process. These changes will be of particular interest to activist shareholders, possibly facilitating their solicitation activities. The proposed rule changes, if adopted, are intended to be applicable to the 2010 proxy season.

- *Allowing Dissidents to Send Unmarked Copies of Management's Proxy Without Triggering All The Proxy Rules.* Rule 14a-2(b) exempts certain solicitations from the proxy rules. The proposed amendment would clarify that a party (other than company management) sending an unmarked copy of management's proxy card to the company's shareholders and requesting that it be returned directly to the company would not render the soliciting party's exemption unavailable (since it would not constitute a form of revocation). This proposed change is significant because it broadens the scope of an exemption that had been effectively limited in 2004 after a decision in the U.S. Court of Appeals for the Second Circuit.[7] We can expect this proposal to generate some controversy, since as one of the Commissioners noted, shareholders may not have significant information about the soliciting person that might be material to their voting decision. The amendments would also clarify that a substantial interest in the matter being considered (which would make the exemption unavailable) may be present even if a soliciting party is not a shareholder.
- *Rounding Out Short Slates.* A proposed amendment to Rule 14a-4(d) would codify recent SEC staff no-action letters permitting a soliciting shareholder to "round out" its short slate of director nominees (a minority of the board if elected) with nominees named in the proxy statements of other dissident shareholders, in the same manner as already permitted by the rule for nominees named in the company's proxy statement.[8] The availability of this rule will be conditioned on the requirement that such dissidents not have agreed to, and must have no intention of, forming a "group" under Section 13(d) of the 1934 Act (often a difficult judgment).
- *Other Proposed Changes.* Currently, under Rule 14a-4(e) a shareholder can grant another individual proxy authority to vote its shares and the recipient of the authority can impose reasonable specified conditions as to whether the shares will be voted. The proposed amendments would clarify the rule to require that any condition imposed by a soliciting party be "objectively determinable." Additionally, the proposals would amend Rule 14a-12 to clarify that information regarding the identity and interests of participants in a solicitation must be available and on file no later than the time shareholders are first solicited.

Proposed Proxy Rules to Implement "Say-On-Pay" for TARP Recipients

Companies that have received or will receive financial assistance under TARP are required by the Emergency Economic Stabilization Act of 2008, as amended ("EESA"), to permit a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to SEC rules including the CD&A, tables and related material. The SEC proposed rules help implement this statutory requirement by specifying and clarifying it in the context of the proxy rules. While the SEC did not prescribe specific language or a form of resolution for the advisory vote, they

directed companies to the text of Section 111(e)(1) of EESA and advised that a vote to approve "compensation policies and procedures" is not specific enough to satisfy EESA and the proposed proxy rules.

The proposed amendments would:

- Require TARP recipients to provide an annual advisory shareholder vote to approve the compensation of executives as disclosed in the company's proxy statement pursuant to Item 402 of Regulation S-K.
  - The requirement would apply during any period that any obligation arising from financial assistance provided under TARP remains outstanding.
  - The shareholder vote would only be required at the company's annual meeting (or any meeting held in lieu thereof).
- Require the disclosure to generally explain the effect of the vote, such as whether the vote is non-binding.
- Require that a proxy statement including such advisory vote be filed in preliminary form (*i.e.*, at least ten calendar days before definitive materials are distributed to shareholders).

What You Should Do Now

The proposed rule changes, if adopted, are intended to be applicable to the 2010 proxy season. TARP companies should review the SEC proposing release.[9] Public comments on the proposal are due 60 days after publication in the federal register.

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If you have any questions on these matters, please do not hesitate to speak with your regular contact at Weil, Gotshal & Manges LLP or members of the Firm's Public Company Advisory Group: Howard B. Dicker, howard.dicker@weil.com, 212-310-8858; Cathy Dixon, cathy.dixon@weil.com, 202-682-7147; Holly J. Gregory, holly.gregory@weil.com, 212-310-8038; P.J. Himelfarb, pj.himelfarb@weil.com, 202-682-7197; Robert L. Messineo, robert.messineo@weil.com, 212-310-8835; and Ellen J. Odoner, ellen.odoner@weil.com, 212-310-8438.

ENDNOTES

[1] Our June 19, 2009 Briefing relating to legislative initiatives is available at http://www.weil.com/files/upload/Weil_Briefing_SEC_CG_June_19.pdf, and our June 23, 2009 Briefing relating to "shareholder access" to company proxy materials is available at http://www.weil.com/files/upload/Weil_briefing_SEC_CG_June_23.pdf.

[2] A copy of the SEC's press release is available at http://www.sec.gov/news/press/2009/2009-147.htm.

[3] The NYSE proposed the amendment on February 26, 2009 and is available at http://www.sec.gov/rules/sro/nyse/2009/34-59464.pdf.

[4] Some of the negative consequences were recognized by the Proxy Working Group ("PWG"), which was created by the NYSE to review the NYSE rules governing the proxy voting process and which ultimately recommended the amendment of Rule 452. *See* Report and Recommendations of the Proxy Working Group to the New York Stock Exchange (June 5, 2006), *available at* http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf. However, the PWG reasoned that, even where no alternative nominee is contesting an election, the election of a director is no longer a routine event in the life of a corporation given the critical role directors are now perceived to play in corporate affairs. In addition, the PWG concluded that eliminating broker discretionary voting would promote greater transparency of the election process and better corporate governance. Moreover, it noted that the definition of a "contested election" has been increasingly questioned, given the rise of "withhold vote" campaigns.

[5] Instead of adopting a majority voting standard, some companies have adopted a "plurality plus resignation policy." They retain a plurality standard for election but adopt a corporate governance policy requiring that a director who does not receive majority support submit his or her resignation. The amendment to Rule 452 raises similar concerns for these companies.

[6] Directors and nominees may be concerned that the disclosure of such qualities (*e.g.*, investment banker) may inappropriately suggest that such person bears greater responsibility for certain decisions than other board members due to his or her expertise in a particular area, and therefore is subject to a higher degree of liability. A similar concern was raised in 2002 when the SEC proposed rules requiring disclosure of the name a company's audit committee financial expert. The SEC addressed this issue by stating that such identification does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and the board of directors in the absence of such designation or identification.

[7] *See MONY Group Inc. v. Highfields Capital Mgmt. L.P.*, 368 F.3d 138 (2nd Cir. 2004). In *MONY*, the court disagreed with the SEC staff's views.

[8] *See* Application of Rule 14a-4(d)(4) to Solicitation for Proposed Minority Slate of Icahn, SEC No-Action Letter (Mar. 30, 2009), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2009/icahnassociates033009-12h3.htm; and Application of Rule 14a-4(d)(4) to Solicitation for Proposed Minority Slate of Eastbourne Capital, L.L.C., SEC No-Action Letter (Mar. 30, 2009), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2009/eastbournecapital033009-sec14.htm.

[9] A copy of the SEC proposing release is available at http://www.sec.gov/rules/proposed/2009/34-60218.pdf.