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SEC PROPOSES NEW COMPENSATION, CORPORATE GOVERNANCE, AND PROXY SOLICITATION RULES

A First Look at Potential New Disclosures for the 2010 Proxy Season

At its open meeting on July 1, 2009, the Securities and Exchange Commission (SEC) approved three measures designed to better inform investors and improve corporate governance:

- enhanced proxy disclosure and solicitation rules (proposed rule);
- requirements for a shareholder advisory vote to approve executive compensation ("say on pay") of TARP¹ recipients (proposed rule); and
- elimination of broker non-votes for director elections.

This alert includes highlights of the enhanced proxy disclosure and solicitation rules and the advisory vote to approve executive compensation of TARP recipients. See our HRO alert dated July 22, 2009 for highlights of the elimination of broker non-votes for director elections.

In anticipation that the proposed rules discussed in this alert may be effective for the 2010 proxy season, we recommend that company boards of directors and board committees become familiar with the proposed rules, monitor developments and status of the rules, and be prepared to implement the final rules, if required.

Proxy Disclosure and Solicitation Enhancements

On July 10, 2009, the SEC released a proposed rule to enhance compensation and corporate governance disclosures, change the time for reporting shareholder voting results and clarify the rules for proxy solicitation communications with shareholders. The purpose of this proposed rule is to improve transparency and provide investors with important and relevant information that would enhance their ability to make informed voting and investment decisions.

The proposed rule is set forth in proposing release, *Proxy Disclosure and Solicitation Enhancements*, (SEC Rel. No. 33-9052; 34-60280). The comment period for the proposal ends on September 15, 2009. If adopted, the final rule would apply to the 2010 proxy season. Below are highlights of this proposed rule:

Expanded Compensation Disclosures

Overall Compensation Practices and Risk Assessment. The proposed rule expands the Compensation Discussion and Analysis (CD&A) disclosure to include a discussion of the company's overall compensation practices (including compensation for non-executives) if the risks arising from such practices may have a material effect on the company. The purpose of this disclosure is to provide investors with material information about how the company "compensates and incentivizes its employees that may create risk." To determine whether, and to what extent disclosure is required, the company will need to identify and perform a risk assessment for each component of its overall compensation program that may have a material effect on the company. The proposing release includes examples of situations that may trigger disclosure (e.g., a business unit with a different compensation structure or a bonus award made upon accomplishment of a task, while the income and risk to the company extends over a significantly longer period of time) and issues that may need to be disclosed for such practices.

¹ Troubled Asset Relief Program

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Amount Reported for Stock and Option Awards. The method for determining the amount reported for stock and option awards granted to executives and directors during the fiscal year would change. As proposed, the full grant date fair value of stock and option awards (including performance awards) granted during the fiscal year would be disclosed in the summary compensation table or the director compensation table. Currently, the amount reported in each table is the amount recognized in the company's financial statements for the fiscal year, which often includes an allocated portion of current and prior year grants. This change would highlight compensation decisions made by the board or committee during the fiscal year (including multi-year grants). In some cases, this may change the identity of the named executive officers required to be reported in the tables for that year (e.g., due to a new-hire grant or performance award). To facilitate year-to-year comparisons, the proposed rule would require the company to restate stock and option awards and total compensation amounts for the prior years covered by the table. However, the company would not be required to include different named executive officers for any preceding fiscal year due to this restatement.

Enhanced Governance Disclosures and Revisions to Proxy Solicitation Rules

Director and Nominee Qualifications and Legal Proceedings. The proposed rule would require enhanced disclosure regarding the specific experience, qualifications, or skills of each director or nominee which qualify that person to serve as a director or committee member. In addition, disclosure would be required of any directorships held by each director or nominee at any time during the past five years at public companies. The time period for disclosure of specified legal proceedings involving directors, executive officers, and nominees would be lengthened from five to 10 years.

Company Leadership Structure. As proposed, the company would be required to disclose its leadership structure and why the company believes it is the best structure. The disclosure would need to discuss whether and why the company has chosen to combine or separate the principal executive officer and board chair positions. If the company has a lead independent director, it would also be required to disclose whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company.

Risk Management Process. The proposed rule would require the company to disclose the board's role in the company's risk management process. The proposing release states that "given the role that risk and the adequacy of risk oversight have played in the recent market crisis," the SEC "believes it is important for investors to understand the board's or board committee's role in this area." Some examples of disclosure include whether the persons who oversee risk management report directly to the entire board or to a specified board committee and whether and how the board, or board committee, monitors risk.

Compensation Consultant – Potential Conflicts of Interest. The current rule requires specific disclosures regarding compensation consultants who perform any role in determining or recommending the amount or form of executive and director compensation. The proposed rule would require additional disclosures if the consultant, or its affiliate, provided additional services to the company. The concern is that fees generated by the provision of additional services, such as benefits administration, human resources consulting, and actuarial services may be more significant than the consulting fees for executive compensation services. The provision of the additional services by the consultants or their affiliates "may create the appearance, or risk, of a conflict of interest that may call into question the objectivity of the consultants' executive pay recommendations." The additional required disclosures would include: information about the nature and extent of the additional services, the fees paid for the consulting services and the fees paid for the additional services, information about who engaged or recommended the consultant, and whether the board or compensation committee approved the additional services.

Shareholder Voting Results – Form 8-K. The proposed rule would accelerate the time for reporting shareholder voting results and transfer the reporting requirement to Form 8-K (new Item 5.07). The results of the shareholder vote would be required to be filed on Form 8-K within four business days after the end of the meeting. Currently, the results must be reported on Form 10-Q (or Form 10-K) for matters submitted to a vote of shareholders during the quarter covered by the report.

Proxy Solicitation Communications. The proposed rule includes a number of changes to the proxy solicitation process, including communications with shareholders. The changes are designed to provide "greater certainty to soliciting parties, help shareholders receive timely and complete information and facilitate shareholder voting."

Comment: If implemented, these changes would require (1) collection of additional information and data (e.g., stock and option awards, director and nominee qualifications and legal proceedings and compensation consultant services and fees); and (2) thoughtful analysis and discussion by the board or board committees (e.g., of the overall compensation risk assessment, the company's leadership structure and the board's role in risk management), all of which may impact the timeline for the company's 2010 proxy statement process. We recommend that companies consider expanding their timeline to prepare and review their 2010 proxy statements to have sufficient time to address any final rule requirements. Similar to the process followed after implementation of the 2006 disclosure changes, the SEC may perform a targeted review of company disclosures implementing the new rules.

Advisory Vote ("Say on Pay") for TARP Recipients

On July 1, 2009, the SEC proposed changes to the proxy statement rules to implement the separate shareholder advisory vote to approve executive compensation required by the Emergency Economic Stabilization Act of 2008 (EESA) for companies that have received financial assistance under the TARP. The comment period for the proposing release, *Shareholder Approval of Executive Compensation of TARP Recipients* (SEC Release No. 34-60218), ends on September 8, 2009. Below are highlights of this proposed rule:

- **Vote.** As required by the EESA, the separate vote would be to approve executive compensation as disclosed in the CD&A, the compensation tables and any related material.
- **Effect of Vote.** The company would be required to disclose that it is providing for the separate shareholder vote on executive compensation in compliance with the EESA, and to briefly explain the general effect of the vote.
- **Annual Meetings.** The advisory vote would be required on a proxy solicited for an annual meeting (or a special meeting in lieu of the annual meeting) for which proxies are solicited for the election of directors.
- **Preliminary Proxy.** The inclusion of the advisory vote triggers the requirement for the company to file a preliminary proxy statement at least 10 calendar days before the definitive proxy materials are first sent to shareholders.
- **Smaller Reporting Company.** A TARP recipient that is a smaller reporting company is not required to include a CD&A in order to comply with this advisory vote requirement.
- **Outcome of Vote.** Disclosure of the result of the advisory vote would be required on Form 8-K, generally within four days of the meeting.

Comment: This proposed rule includes helpful guidance regarding the "say on pay" requirement for TARP recipients (e.g., it clarifies when the vote must be included, that a preliminary proxy statement is required, and that a smaller reporting company which is a TARP recipient remains exempt from the CD&A requirement). In addition, the proposing release provides insight regarding the SEC's view on these issues in the event some form of "say on pay" may become mandatory for all public companies.

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