

HOT TOPICS FOR PUBLIC COMPANY BOARDS OF DIRECTORS AND MANAGEMENT IN 2010

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The current economic climate and regulatory landscape pose unprecedented challenges for public company management and boards of directors. As such, it is critical that directors and management stay abreast of regulatory and legislative initiatives, as well as evolving best practices in corporate governance. This client alert outlines some key issues for directors and management to consider in 2010.

Executive Compensation

Disclosure Regarding Impact of Compensation Policies and Practices on Risk Management

The SEC's new proxy rule amendments, adopted in December 2009 and effective February 28, 2010,¹ will require a company to discuss in its upcoming proxy statement 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. This requirement responds to concerns that the structure and application of incentive compensation policies can in some cases create inadvertent incentives for management and employees to make decisions that significantly increase the company's risk. Required disclosure will vary by company, depending on its compensation arrangements and whether they potentially create material risks to the company. The requirement is principles-based, and the new rule includes examples of situations that potentially could trigger disclosure, as well as the types of issues that would be appropriate for the company to discuss and analyze. This disclosure is not required for smaller reporting companies.

Improved Disclosure

In a November 2009 speech,² Shelley Parratt, the Deputy Director of the SEC Division of Corporation Finance, warned that the SEC Staff is now more likely to require companies to amend filings that do not materially comply with SEC disclosure rules, rather than merely requesting that Staff comments be addressed in future SEC filings. The SEC Staff continues to be concerned about improving executive compensation disclosure in particular, such as disclosure about the reasons for compensation decisions, achievement of performance targets and the identity and selection of peer groups.

¹ Proxy Disclosure Enhancements, Release No. 33-9089 (December 16, 2009) (available at <http://www.sec.gov/rules/final/2009/33-9089.pdf>). See also our client alert describing the new rules, available at <http://www.wcsr.com/resources/pdfs/cs122109.pdf>.

² Available at <http://www.sec.gov/news/speech/2009/spch110909sp.htm>.

Compensation Consultants

The new SEC amendments also require enhanced proxy statement disclosure about the fees paid to compensation consultants in the following circumstances:

- If the board (or compensation committee) has engaged its own consultant to provide advice regarding executive and director compensation and that consultant provides other non-executive compensation consulting services to the company for fees exceeding \$120,000 during the fiscal year, disclosure will be required.
- If the board (or compensation committee) has not engaged its own consultant, if a consultant provides executive compensation consulting services and non-executive compensation consulting services to the company, disclosure is required if the fees for the non-executive compensation consulting services exceeded \$120,000 during the fiscal year.
- Disclosure about consultants that work with management is not required if the board and management have different compensation consultants, even if management's consultant provides additional services to the company.
- Services involving only broad-based non-discriminatory plans or non-customized information are generally not treated as executive compensation consulting services and would not typically trigger disclosure.

In addition, Senator Christopher Dodd's proposed Restoring American Financial Stability Act (the "Dodd Bill"), as well as the Wall Street Reform and Consumer Protection Act, which was passed by the House of Representatives in December 2009 (the "Wall Street Act"), would require that any compensation consultants or other similar advisors to the compensation committees of listed companies be independent. The Shareholder Empowerment Act of 2009, introduced by Representative Gary Peters in June 2009 (the "Shareholder Empowerment Act"), also would require that any consultants retained to advise on executive compensation or employment contracts be independent and report solely to the board or a board committee. The Treasury Department also announced in 2009 that it will propose rules enhancing the independence requirements for compensation committee members, giving compensation committees the power to use outside advisors and directing the SEC to establish standards for ensuring the independence of such advisors. Although it cannot be predicted whether and to what extent these legislative initiatives will be adopted, companies should expect many aspects of the proposed laws to become best practices at a minimum.

Say on Pay

Boards should prepare for the fact that public companies may soon be required to give their shareholders an advisory vote on executive compensation, also known as "say on pay." Several pending legislative items, including the Dodd Bill, the Wall Street Act and the Shareholder Bill of Rights Act, introduced by Representative Charles Schumer in May 2009, would require public companies to hold an annual nonbinding shareholder vote on executive compensation and a separate nonbinding shareholder vote on golden parachutes. Companies participating in the Troubled Asset Relief Program ("TARP") are already required to give their shareholders a say on pay vote, and the Treasury Department announced in June 2009 that it will support legislation authorizing the SEC to require annual nonbinding say on pay votes for all public companies. The Treasury Department proposal would also give shareholders the right to cast a nonbinding vote on golden parachutes related to mergers or similar change in control transactions. Some companies (such as Microsoft) have voluntarily agreed to include management say on pay votes at their annual shareholder meetings.

Scrutiny of Pay Practices

In its 2010 Corporate Governance Policy Updates,³ RiskMetrics Group (“RMG”) introduced a new Executive Compensation Evaluation policy, incorporating its existing Pay for Performance, Options Backdating and Poor Pay Practices policies, along with the existing guidelines on evaluating Management Say-on-Pay (“MSOP”) resolutions. This updated policy provides a framework for RMG to determine its voting recommendation in cases where pay practices raise concerns. The MSOP proposal, if included in a proxy statement, will be RMG’s primary means to voice opposition to what it considers problematic pay practices, although RMG may also issue negative recommendations on compensation committee members (or the board) and/or equity-based incentive plan proposals in certain circumstances. Within this new framework, there are also two notable updates to RMG’s policies:

- The Pay for Performance evaluation will include a consideration of the alignment of the CEO’s total direct compensation and total shareholder return over a period of at least five years.
- The Poor Pay Practices evaluation will include consideration of whether incentive practices may motivate inappropriate risk-taking by executives. This evaluation will also assess the extent to which techniques such as clawback policies or stock ownership and/or holding requirements may mitigate this risk.

In addition, in September 2009, the Conference Board Task Force on Executive Compensation issued recommendations for corporate institutions to restore credibility and increase trust in pay practices and oversight.⁴ Included in the report are a set of guiding principles, which state that public companies should:

- Establish a clear link between pay, strategy and performance;
- Provide compensation that is fair, affordable and clearly aligned with actual performance;
- Eliminate controversial compensation practices that conflict with the notions of fairness and pay for performance – such as excessive golden parachutes, overly generous severance arrangements, gross-ups of parachute payments or perquisites and golden coffins – unless specific justification exists;
- Demonstrate credible board oversight of executive compensation; and
- Foster transparency with respect to compensation practices and appropriate dialogue between boards and shareholders.

Recent Treasury Department initiatives and proposed legislation, such as the Dodd Bill, also seek to impose greater responsibilities on compensation committees to review and disclose compensation and limit problematic pay practices.

Clawbacks

Section 304 of the Sarbanes-Oxley Act currently imposes a clawback requirement on a public company’s CEO and CFO if the company has to issue a financial restatement because of material noncompliance, due to misconduct, with financial reporting requirements under the federal securities laws.⁵ Proposed legislation would broaden the application of clawbacks. For example, the Shareholder

³ RiskMetrics Group 2010 Corporate Governance Policy Updates and Process, available at http://www.riskmetrics.com/policy/2010/policy_information. A comprehensive summary of RMG’s Proxy Voting Guidelines, including the compensation decisions that RMG considers to be Poor Pay Practices, is available at http://www.riskmetrics.com/sites/default/files/RMG_2010_US_SummaryGuidelines20100108.pdf.

⁴ Available at http://www.conference-board.org/pdf_free/ExecCompensation2009.pdf.

⁵ See our client alert regarding a recent SEC enforcement action under Section 304, available at http://www.wcsr.com/resources/pdfs/cs_072809.pdf.

Empowerment Act would require a public company to develop and disclose policies for reviewing, and recovering or canceling if feasible, any performance-based compensation made to its executive officers based on fraud, financial results that require restatement or other causes specified by the SEC. The Dodd Bill would mandate clawback policies enabling the recovery of incentive-based compensation from current or former executives following a restatement. Such clawback policies are currently required for TARP recipients and are generally considered a best practice for other companies.⁶

Severance Arrangements

Severance arrangements have also faced increased scrutiny in recent years; institutional investor groups such as RMG consider overly generous severance arrangements to be a poor pay practice. The Shareholder Empowerment Act would prohibit a public company's board of directors or board committee from entering into an agreement providing for severance payments to any senior executive officer who is terminated due to poor performance. The bill would also require that poor performance, as determined by the board, be included in the definition of "cause" in agreements that allow for a senior executive to be terminated for cause.

Revisions to Summary Compensation Table and Director Compensation Table

The SEC's new proxy amendments revise the current Summary Compensation Table and Director Compensation Table to require disclosure of the aggregate grant date fair value of stock and option awards computed in accordance with FASB ASC Topic 718,⁷ in lieu of the currently required disclosure of the dollar amount recognized in the relevant fiscal year for financial statement reporting purposes. The SEC believes that disclosure of the full grant date fair value of these awards permits investors to better evaluate the amount of equity compensation awarded. Notably, this rule change may result in different individuals being treated as "named executive officers" in proxy statements, so companies must be poised to recalculate total compensation based on the different calculations of stock award value. The amendments will also require companies to recalculate prior years' award values for presentation in the 2010 proxy statement.

Director Elections

Majority Voting

Majority voting for directors remains a hot issue in corporate governance. Under the plurality voting framework, nominees in an uncontested election can remain on the board even when they do not receive a majority of the votes cast. Some companies with plurality voting bylaws have adopted resignation policies requiring that a nominee who receives less than a majority of the vote must submit his resignation. Nonetheless, shareholder activists continue to urge companies to adopt a majority voting framework. The proposed Shareholder Bill of Rights Act and Shareholder Empowerment Act would both require majority voting in uncontested director elections. The Shareholder Bill of Rights Act would also mandate annual elections for public company boards, thereby eliminating staggered boards.

Loss of Broker Discretionary Votes

As a result of changes to NYSE Rule 452 that became effective January 1, 2010, brokers that do not receive specific voting instructions from customers holding their shares in "street name" will no longer be able

⁶ See our client alert discussing clawbacks and "hold 'til retirement" provisions, available at <http://www.wcsr.com/resources/pdfs/cs012609.pdf>.

⁷ Formerly referred to as FAS 123R.

to vote those shares in director elections.⁸ In past years, management has been able to count on most brokers voting the uninstructed shares of their customers in favor of management's slate of nominees. Now, management will no longer be able to assume that street name shares will be cast for management's slate. This change could have a major impact on public companies whose uncontested director elections are no longer governed by plurality voting, and at mid- and small-cap companies, which tend to have more retail shareholders. In preparation for this rule change, companies with majority vote provisions or resignation policies, as well as other vulnerable companies, should evaluate their historical voting patterns to determine the extent to which they can expect problems in obtaining sufficient support for their director slates. Some companies, particularly those with large retail ownership, may need to step up their investor communication efforts to encourage retail shareholders to provide voting instructions to brokers.

Increased Disclosure About Director Nominees

The new SEC proxy rule amendments will require increased disclosure about director candidates in upcoming proxy statements. Currently, the SEC proxy rules require brief biographical disclosure about directors and director nominees and general disclosure about director qualification requirements. The new amendments will supplement this information by requiring, for each director and director nominee, disclosure of the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company. The new disclosure will be required for all nominees (including shareholder nominees) and for all directors, including those not up for reelection in a particular year. The amendments do not specify the particular information that should be disclosed; companies will have the flexibility to determine what information about a director or nominee's skills, qualifications or particular area of expertise should be disclosed to shareholders.

In addition, the SEC now requires disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director. If the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, disclosure will be required of how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of this policy. Companies will be allowed to define diversity in ways that they consider appropriate.

The amendments also expand the existing requirement to disclose other directorships currently held by directors and nominees to include any such directorships held at any time during the past five years (even if the director or nominee no longer serves on that board). Finally, the current SEC disclosures regarding specified legal proceedings involving directors, executive officers and director nominees over the past five years have been enhanced to include an expanded list of such proceedings during the past 10 years. Companies should revise their D&O questionnaires to capture these additional disclosures and should also review (and possibly revise) their nominating committee charters, corporate governance guidelines and other governance documents to address these disclosure requirements.

Risk Management

The global economic crisis has highlighted the need for companies to anticipate, identify and manage risk in a comprehensive manner. As noted above, companies now must discuss the interplay between compensation policies and risk in their proxy statements. In addition, the SEC amendments require the proxy statement to include a description of the board's role in the oversight of risk of the company, such as how the board administers its oversight function, and its effect on the board's leadership structure. The SEC has created a new Division of Risk, Strategy and Financial Innovation as part of its focus on risk oversight

⁸ See our client alert describing the changes to Rule 452, available at <http://www.wcsr.com/resources/pdfs/cs070609.pdf>.

mechanisms, and has also indicated a willingness to allow shareholder proposals focused on the board's role in the oversight of a company's management of risk.⁹

Pending legislation also addresses risk management by boards of directors. For instance, under the Shareholder Bill of Rights Act, public companies would be required to maintain a risk committee comprised entirely of independent directors to establish and evaluate the company's risk management practices. The Dodd Bill would impose a more limited risk committee requirement.

Compliance Programs

The need to maintain an effective corporate compliance program remains a high priority for management and boards of directors. Companies face increased exposure to investigations and enforcement actions by government regulators and enforcement authorities. The long-standing rule that corporations can be held liable whenever an employee commits a crime for the benefit of the corporation and within the scope of his or her employment was recently upheld by the Second Circuit Court of Appeals.¹⁰ As a result, it is vital for a public company to maintain not only written compliance policies, such as codes of ethics and conduct and policies dealing with specific legal requirements, but also procedures for implementing, updating and monitoring such policies.

CEO Succession Planning

The board's role in selecting and evaluating a company's CEO and senior leadership, and planning for their succession, is a critical element of the company's strategic plan. A leadership gap can undermine public confidence in the company and cripple the company's ability to respond to immediate challenges. As a result, shareholder activists are submitting more shareholder proposals requesting that companies adopt and disclose written and detailed CEO succession planning policies. The SEC recently announced that companies generally may no longer rely on Rule 14a-8(i)(7) to exclude such proposals because the SEC believes that they "raise a significant policy issue regarding the governance of the corporation that transcends the day-to-day business matter of managing the workforce."¹¹

Board Leadership

The new SEC rules amend the existing proxy rules to require disclosure about the board's leadership structure, including:

- Whether and why the company 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 appropriate; and
- If one person serves as both principal executive officer and chairman of the board, whether the company has a lead independent director and what specific role that director plays in the leadership of the company.

The issue of separating the CEO and chairman roles has also been addressed in proposed federal legislation, including the Shareholder Bill of Rights Act and the Shareholder Empowerment Act.

⁹ Shareholder Proposals, Staff Legal Bulletin No. 14E (October 27, 2009) (available at <http://www.sec.gov/interps/legal/cfsbl14e.htm>) (SLB 14E).

¹⁰ U.S. v. Ionia Management, S.A., 555 F.3d 303 (2d Cir. 2009).

¹¹ SLB 14E.

Shareholder Communications

As reform initiatives such as proxy access and say on pay gain strength, shareholders are finding that they have a greater voice in corporate governance. Directors and management face increased pressure to make strong investor relations and shareholder engagement a priority. However, as communications with shareholders and others increase, companies must be aware of Regulation FD, which prohibits selective disclosure of material nonpublic information. In 2009, the SEC announced a settlement under Regulation FD which emphasized the importance of Regulation FD compliance programs.¹²

Shareholder Proxy Access

In 2009, the SEC proposed new proxy access rules that would allow shareholders meeting certain requirements to include their nominees for director in the company's proxy materials unless the shareholders are otherwise prohibited from doing so by state law or a company's governing documents.¹³ In connection with its recent adoption of proxy rule amendments, the SEC announced that it has reopened the public comment period for the shareholder director nomination proposal to seek views on additional data and related analyses received by the SEC after the close of the original public comment period on August 17, 2009.¹⁴ The SEC staff expects to make a final recommendation to the SEC early in 2010. Several legislative proposals, such as the Dodd Bill, the Shareholder Bill of Rights Act and the Shareholder Empowerment Act, would also require shareholder access to the proxy statement in director elections.

In addition, Delaware recently adopted changes to its corporation laws permitting Delaware corporations to adopt bylaw provisions allowing stockholders greater access to the company's proxy materials for director nominations and providing that stockholders may be reimbursed for such proxy solicitation expenses.¹⁵ The Model Business Corporation Act and other state corporation laws may adopt a similar framework in the future.

Takeover Defense

Boards should review their takeover defenses and areas of potential exposure to takeover pressures. Institutional investors tend to disfavor poison pills as vehicles for management entrenchment. For example, in its 2010 Corporate Governance Policy Updates, RMG announced that it will now recommend a vote against or a withhold vote on all nominees for a board of directors that has adopted a poison pill with a term of more than 12 months, or renewed an existing pill, including a pill with a term of 12 months or less, without shareholder approval. Companies with classified boards will be reviewed every year, and companies with annually-elected boards will be reviewed at least once every three years.

¹² See our client alert describing the Regulation FD settlement, available at <http://www.wcsr.com/resources/pdfs/cs093009.pdf>.

¹³ Facilitating Shareholder Director Nominations, Release No. 33-9046 (June 10, 2009) (available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>). Our client alert regarding the proposals is accessible at <http://www.wcsr.com/resources/pdfs/cs052709.pdf>.

¹⁴ SEC Re-Opens Public Comment Period for Shareholder Director Nomination Proposal (December 14, 2009) (available at <http://www.sec.gov/news/press/2009/2009-265.htm>).

¹⁵ Sections 112 and 113 of the Delaware General Corporation Law.

Financial Disclosure

Early in 2009, the SEC adopted final rules mandating that certain financial data be disclosed in eXtensible Business Reporting Language, or XBRL.¹⁶ Domestic and foreign large accelerated filers with a worldwide public common equity float above \$5 billion are already required to comply with this requirement, but the remainder of large accelerated filers must provide the disclosures in their first Form 10-Q for a fiscal quarter ending on or after June 15, 2010.

In addition, the SEC is still considering requiring the use of International Financial Reporting Standards (“IFRS”) by U.S. public companies.¹⁷ Current SEC rules and regulations require that all U.S. public companies file financial statements prepared in accordance with U.S. generally accepted accounting principles. In response to the increasing acceptance of IFRS in major capital markets throughout the world, the SEC has proposed a roadmap consisting of milestones that could potentially lead to the mandatory use of IFRS by U.S. public companies beginning in 2014.

Conclusion

While some of the matters discussed in this alert have not yet been enacted or adopted, in many cases they represent emerging best practices for public company boards and management. Those that have been enacted or adopted are generally effective for the 2010 proxy season, so it is important for boards and management to take steps toward immediate compliance. If you have any questions regarding the matters discussed in this client alert, please contact [Meredith Burbank](#), the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: <http://www.wcsr.com/profSearch?team=corporateandsecurities>.

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¹⁶ Interactive Data to Improve Financial Reporting, Release No. 33-9002 (January 30, 2009) (available at <http://www.sec.gov/rules/final/2009/33-9002.pdf>). See also our client alert, available at <http://www.wcsr.com/resources/pdfs/cs021109.pdf>.

¹⁷ Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, Release No. 33-8982 (November 14, 2008) (available at <http://www.sec.gov/rules/proposed/2008/33-8982.pdf>). See also our client alert, available at <http://www.wcsr.com/resources/pdfs/cs112508.pdf>.