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Corporate Governance Group Client Alert

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SEC PROPOSES NEW RULES FOR ENHANCED PROXY STATEMENT COMPENSATION AND CORPORATE GOVERNANCE DISCLOSURES

Background

In a release published on July 10, 2009 (the “Release”),¹ the Securities and Exchange Commission (the “SEC”) proposed amendments to the federal proxy rules aimed at providing investors with additional “useful and meaningful” information in order to “enhance their ability to make informed voting and investment decisions.” These proposals come on the heels of the SEC’s recent proposed rule granting shareholders access to company proxy statements to nominate director candidates, as well as the elimination of broker discretionary voting on elections of directors.²

The proposed amendments are designed to enhance disclosures relating to activities that “materially contribute to a company’s risk profile,” including company compensation policies, executive and director equity awards, director qualifications, company leadership structure, potential conflicts of interests of compensation consultants and the board’s role in risk management. The new disclosure requirements are rooted in three themes focused on in the Release: (1) enhanced transparency, (2) assessment and management of risk and (3) boosting investor confidence. The SEC also proposes in the Release to accelerate the reporting of voting results, as well as to revise certain rules governing proxy solicitation.³

¹ See Release No. 33-9052 entitled “Proxy Disclosure and Solicitation Enhancements”, which is available on the SEC website at <http://sec.gov/rules/proposed/2009/33-9052.pdf>.

² For further discussion, see our Client Alerts entitled “SEC Proposes Long-Awaited Proxy Access Rules” (dated June 22, 2009) and “SEC Approves NYSE Rule Amendment Eliminating Broker Discretionary Voting in All Elections of Directors, Whether or Not Contested” (dated July 16, 2009).

³ The proposed revisions include amending Rule 14a-4(d) to allow a person soliciting in support of nominees who, if elected, would not constitute a majority of the board to seek authority to vote for another soliciting person’s nominees in addition to, or instead of, the issuer’s nominees. For further discussion, see our Client Alert entitled “SEC Permits Stockholder Proposing Minority Slate to ‘Round Out’ Solicitation With Nominees of Competing Stockholder” (dated April 13, 2009).

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided at the end of this alert.

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The Release contains numerous requests for comments, some specific and others far-reaching. Hence, it is possible that the final rules could differ, and in some respects perhaps significantly, from the proposals. The public comment period is set to expire on September 15, 2009. If the amendments proposed in the Release are adopted, the SEC anticipates that they will be effective for the 2010 proxy season.

Compensation Discussion & Analysis Disclosure

The proposed amendments would expand the Compensation Discussion & Analysis (“CD&A”) included in annual proxy statements by requiring companies to provide information about whether their overall compensation policies and practices for employees create “risk taking incentives” that can affect companies’ risk and management of that risk. The SEC believes that “investors would benefit from an expanded discussion and analysis about how the company rewards and incentivizes its employees” due to the fact that “at some companies, compensation policies have become disconnected from long-term company performance because the interests of management ... and the long-term well being of the company are not sufficiently aligned.”

Specifically, the proposed amendments would add a new section to Item 402 of Regulation S-K requiring a company “to discuss and analyze its broader compensation policies and overall actual compensation practices for employees generally, including non-executive officers, if risks arising from those compensation policies or practices may have a material effect on the company.” The SEC anticipates that companies, in preparing this new disclosure, “will need to consider the level of risk that employees might be encouraged to take to meet their incentive compensation elements.”

The proposed rules provide examples of issues that a company may need to address in connection with the new CD&A disclosure requirements, such as:

- The “design philosophy” of compensation policies that relate to or affect risk taking by employees;
- The risk assessment or incentive considerations used in structuring compensation policies or in making compensation decisions;
- The relationship between compensation policies and the long-term and short-term realization of risks resulting from the actions of employees (such as through mandating claw-back policies or holding periods);
- Any policies relating to possible adjustments of compensation policies to address changes in risk profiles and any material adjustments made to compensation policies or practices due to changes in risk profiles; and
- The extent to which compensation policies are monitored to determine whether “risk management objectives are being met with respect to incentivizing ... employees.”

The proposed rule also sets forth a non-exclusive list of examples of situations that potentially could trigger discussion and analysis under the proposed amendments, including compensation policies and practices:

- At a business unit that carries a significant portion of the company’s risk profile;

- At a business unit with compensation structured differently from that of other units within the company;
- At business units that are significantly more profitable than others within the company;
- At business units where the compensation expense is a significant percentage of the unit's revenues; or
- Of the company that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

Reporting of Equity Awards

The proposed amendments also would revise the manner in which stock and option awards are disclosed in the Summary Compensation Table ("SCT") and Director Compensation Table ("DCT"). Specifically, the proposed amendments would amend Item 402 of Regulation S-K to require disclosure of the *aggregate grant date fair value of awards* computed in accordance with FAS 123R. Currently, companies are required to disclose the *dollar amount recognized for financial statement reporting purposes* for the fiscal year in accordance with FAS 123R. This revised method of calculation also would be used for determining which executives, in addition to the principal executive officer and principal financial officer, constitute "named executive officers" ("NEOs") for SCT reporting purposes.

The proposed amendments also would:

- Rescind the requirement to report the full grant date fair value of each individual equity award in the Grants of Plan-Based Awards Table and corresponding footnote disclosure to the DCT; and
- Amend Instruction 2 to the SCT to provide that companies will no longer be required to report the amount of salary or bonus forgone at an NEO's election in the salary and bonus columns; instead, the non-cash awards received in lieu of foregone salary and bonus would be reportable in the column applicable to the form of award elected.

Enhanced Director and Nominee Disclosures

The proposed amendments to Item 401 of Regulation S-K build upon the current disclosure rules regarding the qualifications of directors and nominees by requiring a company to *specifically* describe:

- Each director's and nominee's "specific experience, qualification, attributes or skills" (including "risk assessment skills") that qualify that person to serve as a director, and as a member of any committee on which such person serves or is chosen to serve, in relation to the company's business model, with the goal of allowing investors to determine whether a director, and the entire board, has the capability to appropriately "assess risk and respond to complex financial and operational challenges"; and

- Any directorships held at public companies by a director or nominee at any time during the *previous five years* (the current disclosure rules only require a list of *current* directorships), and any relevant legal proceedings occurring in the previous *ten years* (the current disclosure rules only require the previous *five years*).

Company Leadership Structure and the Board's Role in Risk Management

The proposed amendments to Item 407 of Regulation S-K would require disclosure of a company's "leadership structure," together with an explanation why this particular structure best fits the company. The SEC hopes that the additional disclosures will provide insight into how a company "perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company."

In particular (and touching on a hot button issue for corporate governance advocates), a company would be required to disclose why it has combined or separated the principal executive officer and board chair positions. Where the positions are combined, a company would have to disclose whether and why it has a lead independent director and specifically describe such director's role in company leadership.

The proposed rules also would require additional disclosure about the board's role in a company's risk management process, including "credit risk, liquidity risk, and operational risk." Such disclosure would include whether the risk management function is implemented through the whole board or a committee.

New Disclosure Regarding Compensation Consultants

Currently, companies are required to provide disclosures in their annual proxy statements regarding compensation consultants used by the company, including a description of any role played by compensation consultants in determining or recommending the amount or form of executive and director compensation, the identity of such consultants and a statement as to whether they are engaged directly by the compensation committee or any other person.

The proposed amendments would amend Item 407 of Regulation S-K to require additional disclosure of the consultants' provision of other services to the company "when they play any role in determining or recommending the amount or form of executive and director compensation" (other than in connection with certain broad-based plans).

In such case, a company would be required to disclose:

- The nature and extent of all additional services provided to the company during the last fiscal year by the compensation consultant or its affiliates;
- The aggregate fees paid to the compensation consultant or its affiliates for work related to determining or recommending the amount or form of executive and director compensation
- The aggregate fees paid to the compensation consultant or its affiliates for all additional services to the company;

- Whether the decision to engage the compensation consultant or its affiliates for additional compensation services was made, recommended, subject to screening or reviewed by management; and
- Whether the board or the compensation committee has approved all additional services of the compensation consultant or its affiliates in addition to executive compensation services.

Reporting of Voting Results on Form 8-K

The SEC also proposes in the Release to transfer the disclosure of shareholder voting results from Forms 10-Q and 10-K to Form 8-K. Concerned with the usefulness of potentially stale information, the SEC proposal would require a company to disclose the results of a shareholder vote on a Form 8-K within four business days after the conclusion of the meeting. If voting results have not been definitely determined by then (as often happens in a proxy contest), the preliminary results would be required to be reported on the Form 8-K, with an amendment to disclose the final results within four business days following their certification.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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