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Hot Topics for the 2010 Proxy Season

The SEC's New Proxy Disclosure Rules

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Director Disclosures—Specific Qualifications

- For each director or person nominated or chosen to become a director
 - Company must detail the specific experience, qualifications, attributes and skills that led to the conclusion that the person should serve as a director
 - Disclosures are to be made in light of the company's business and structure at the time of filing
- New disclosures are in addition to existing requirement regarding the specific minimum qualifications and specific qualities or skills used by the nominating committee

Director Disclosures—Specific Qualifications (Cont'd)

- New rule does *not* specify particular information that should be disclosed
- Consider discussing the following attributes:
 - Risk assessment
 - Financial reporting/auditing experience
 - CEO or other leadership experience
 - Industry specific experience
 - International experience
 - Public policy experience
 - Academic experience
 - Legal or regulatory experience

Director Disclosures—Specific Qualifications (Cont'd)

- Cannot provide this disclosure on a group basis for directors or nominees sharing similar characteristics
 - Insufficient to disclose that a group of directors are each an audit committee financial expert or a current or former CEO of a major company
- Consider adding as part of director biographies
 - Emphasizing particular aspects of the director's resume
 - Characterizing the skills attained from particular work experience
- Could include this disclosure in section discussing nominating procedures as long as directors' qualifications are discussed individually

Director Disclosures—Specific Qualifications (Cont'd)

- No need to disclose specific experience, qualifications, attributes or skills that qualify a person to serve as a committee member
 - Skills relevant to committee service may be relevant as part of the specific qualifications considered for board service
- In a proxy contest, proponent also has to comply with the specific qualifications disclosure requirement in its proxy materials

Director Qualifications—Staggered Boards

- When a board is staggered, there will be directors who do not stand for re-election in any given year
- Even in this case the relevant time period for the specific qualifications is as of the time that the filing containing the disclosure is made
- Consider implementing a disclosure control to address the determination with respect to directors not up for re-election

Director Disclosures—Gathering the Information

- Discussions with chair of nominating committee or committee as a whole
- Including a question in the D&O questionnaire
- Completing a skills matrix
- Whatever method is used, give the board members an opportunity to see the new disclosures
 - Their own descriptions
 - Descriptions of the other directors

Director Qualifications—Board or Committee Action

- The new disclosure requirement asks what led to the conclusion that each director or nominee should serve as a director
- There should be some Board or committee action relating to this requirement
 - Agenda item
 - Resolution
- While companies presumably were already considering specific qualifications in the nominating process, it would be helpful to have a written record to back up the disclosure

Director Qualifications-precedent

- Proxy contest proxy statements may serve as a source for precedent
- Covidien filed a proxy statement in January with descriptions of specific qualifications following each biography, such as:
 - With his years of managerial experience, both at Eaton and at General Electric, Mr. Arnold brings to the Board of Directors demonstrated management ability at senior levels. His position as Chief Operating Officer of the Eaton Industrial sector gives Mr. Arnold critical insights into the operational requirements of a large company. In addition, in previously serving on the Audit Committee of another public company, Mr. Arnold gained valuable experience dealing with accounting principles and financial reporting rules and regulations, evaluating financial results and generally overseeing the financial reporting process of a large corporation.

Board Diversity

- Disclose whether and, if so, how a nominating committee or the board considers diversity in identifying nominees for director
- If either the nominating committee or the board has a board diversity policy, disclose
 - how this policy is implemented
 - how the nominating committee or the board assesses the effectiveness of its policy

Board Diversity (Cont'd)

- Rule does not define diversity
- Adopting Release expressly recognizes:
 - “companies may define diversity in various ways, reflecting different perspectives” and that “some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin.”

Board Diversity (Cont'd)

- Some companies may have a free standing board diversity policy
- Many companies address the diversity of skills and backgrounds sought for board members in their corporate governance guidelines
 - Consider whether this constitutes a board diversity policy
 - To the extent it does, additional disclosures are required
- Some companies may adopt a formal board diversity policy or amend their corporate governance guidelines before their proxy statements are distributed this year

Board Diversity (Cont'd)

- Some companies may disclose that they have no formal diversity policy, with a description of attributes generally considered that relate to diversity
- Emphasize that all directors represent all shareholders, even in the context of diversity
- Board diversity disclosure was not in the original proposal so advise board or nominating committee that this new disclosure is coming

Additional Board and Executive Officer Disclosures

- Disclosure public company directorships held by directors over the past 5 years (not just current directorships) need to be disclosed, even if not currently held
 - Be sure to address this in the D&O questionnaire
 - Useful to collect information regarding dates of service and committee memberships
- Time period for involvement in legal proceedings expanded to 10 years (from 5 years)
 - Be sure to address this in the D&O questionnaire
 - This requirement applies to executive officers as well as directors

Expanded Legal Proceedings

- Any federal or state judicial or administrative order, judgment, decree or finding not subsequently reversed, suspended or vacated, that results from involvement in mail or wire fraud or fraud in connection with any business entity
- Any federal or state judicial or administrative order, judgment, decree or finding not subsequently reversed, suspended or vacated, based on violations of federal or state securities or commodities law or regulation, or any law or regulation respecting financial institutions or insurance companies
- Any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or a self-regulatory organization

Expanded Legal Proceedings (Cont'd)

- Disclosure is not required in response to wire or business entity fraud or securities, commodities, financial institution or insurance law or regulation with respect to any settlement of civil proceedings among private litigants
- None of these proceedings need be disclosed if they are not material to an evaluation of the ability or integrity of a director, nominee or executive officer
 - This is consistent with the current requirements for disclosure of legal proceedings

Leadership Structure of the Board

- New Reg S-K Item 407(h)
- Briefly describe the leadership structure of the board
 - This relates to leadership structure of the board itself, not management leadership structure
 - Includes whether same person serves as both CEO (principal executive officer) and chair of board
 - In case of registered investment company, includes whether the chair of board is an “interested person”
 - In either of the foregoing cases, disclose whether the company has a lead independent director, and what specific role that lead independent director plays in the leadership of the board
 - Indicate why the company has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the company

Board's Role in Risk Oversight

- Disclose the extent of the board's role in the risk oversight of the company.
 - Risk “oversight” as distinct from risk “management”
 - This includes:
 - How the board administers its oversight function. E.g.:
 - Through the whole board
 - Through the audit committee or a separate risk committee
 - May wish to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the whole board or to a board committee, or how the board or committee otherwise receives information from such individuals
 - The effect that this has on the board's leadership structure

Board's Role in Risk Oversight

- Categories of risk cited in release
 - Operating companies:
 - Credit risk
 - Liquidity risk
 - Operational risk
 - Funds:
 - Investment risk
 - Compliance
 - Valuation

Compensation Policies as Related to Risk Management

- New Reg S-K Item 402(s)
- Narrative disclosure of the company's compensation policies and practices as they relate to the company's risk management
 - To the extent that risks arising from the company's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the company, discuss the company's policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives

Compensation Policies as Related to Risk Management

- Motivated by sense that compensation structures within financial institutions may have rewarded short-term profit, without regard to longer-term risks to institution, in a manner which may have played a significant contributory role in creating 2008 systemic credit crisis
 - Why not a problem in the past?
- Covers all employees, not just executive officers

Compensation Policies as Related to Risk Management

- Disclosure requirement only triggered at threshold of “reasonably likely” to cause MAE
 - Is same disclosure threshold as for MD&A disclosure requirement regarding known trends and uncertainties that are material to the business
 - Lower than “more likely than not”
 - Higher than FAS 5 disclosure trigger threshold of “reasonably possible,” which covers everything above the level of “remote”
 - Triggers off of material “adverse” effect, not just any material effect
 - Offsetting or compensating steps or controls designed to limit risks of certain compensation arrangement can be considered in this regard

Compensation Policies as Related to Risk Management

- Is not part of CD&A
 - Rules do not specify where the disclosure must appear, but staff recommends it be presented with the company's other Item 402 (executive compensation) disclosure
- If company concludes no disclosure in this regard is required under Item 402(s), no affirmative statement is required to the effect that the company has determined that risks arising from its compensation policies and practices are not reasonably likely to have an MAE
- Even if no Item 402(s) disclosure triggered, to the extent that risk considerations are a material aspect of the company's compensation policies or decisions for NEOs, the company is required to discuss them as part of its CD&A

Compensation Policies as Related to Risk Management

- Release provides nonexclusive list of situations where compensation programs may have the potential to raise material risks. Includes 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 significantly differently than other units
 - At a business unit that is significantly more profitable than other units
 - At a business unit where compensation expense is a significant percentage of the unit's revenues

Compensation Policies as Related to Risk Management

- 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

Compensation Policies as Related to Risk Management

- If disclosure in this regard is required, examples of the issues which companies may need to address include:
 - The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by those employees on behalf of the company, and the manner of their implementation
 - The company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation

Compensation Policies as Related to Risk Management

- How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term
 - Such as through policies requiring clawbacks or imposing holding periods
- The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile
- Material adjustments the company has in fact made to its compensation policies and practices as a result of changes in its risk profile
- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing employees

Changes to the Summary Compensation Table/Director Compensation Table

- Stock and option awards will now be reported based on the grant date fair value
 - Grant date fair value is to be calculated in accordance with ASC Topic 718 (formerly FAS 123R) rather than the dollar amount expensed during the year for financial statement reporting purposes
 - Performance-based awards are to be calculated based on their probable outcome in accordance with ASC Topic 718, with a footnote added to the table disclosing the award's potential maximum value, assuming the highest level of performance conditions will be achieved if a lesser amount was included in the table
 - As before, the new calculations must exclude the effect of estimated forfeitures

Changes to the Summary Compensation Table/Director Compensation Table (cont.)

- Reverses surprise SEC rulemaking from December of 2006
- Equity awards to be reported are those granted during a year, rather than those granted to award performance for a year (no matter when granted)
 - If this method of presentation doesn't present a fair understanding of the compensation disclosures, SEC suggests consideration of inclusion of supplemental tabular disclosure with respect to the equity grants

Changes to the Summary Compensation Table/Director Compensation Table (cont.)

- The dollar amounts for all years presented will need to be recalculated to provide a consistent manner of presentation although it doesn't require a redetermination of who the named executive officers are for a specific year
- If an equity award is granted in a year and then forfeited during the same year because the executive officer leaves the company, the full grant date fair value must be included for purposes of determining the person's total compensation for that year and identifying named executive officers

Compensation Consultant Fee Disclosures

- Disclosure of fees paid to compensation consultants and their affiliates will now be required under certain circumstances if the consultant played a role in determining or recommending the amount or form of executive or director compensation and also provided additional services to the company
- If the compensation committee or the board engages its own consultant , disclosure is required if the consultant or its affiliates provided more than \$120,000 of additional services to the company or its affiliates during the last fiscal year

Compensation Consultant Fee Disclosures (cont.)

- If neither the compensation committee nor the board engaged its own consultant, but management did, disclosure is required if that consultant or its affiliates provided more than \$120,000 of additional services
- If disclosure is required, the aggregate fees paid for director and executive compensation services and the aggregate fees paid for the additional services must be separately disclosed

Compensation Consultant Fee Disclosures (cont.)

- If the compensation consultant was engaged by the compensation committee and disclosure is required, the disclosure must also state
 - Whether the decision to engage the consultant or its affiliates for the additional services was made or recommended by management, and
 - Whether the board or the compensation committee approved the additional services
- If disclosure is required, the nature and extent of additional services are not required to be described

Compensation Consultant Fee Disclosures (cont.)

- Services involving only broad-based non-discriminatory plans or the provision of surveys that are not customized for the company or that are customized based on parameters that are not developed by the consultant are not consulting services with respect to the amount or form of executive or director compensation and do not need to be disclosed if they are the only services provided by the consultant

Compensation Consultant Fee Disclosures (cont.)

- Consulting on broad-based non-discriminatory plans does not include any related services, such as benefits administration, human resources services, actuarial services and merger integration services, all of which are additional services
- Similarly if the non-customized information of surveys relates to matters other than executive and director compensation, then the fees for such information would be for additional services

Form 8-K Requirements

- A requirement to disclose the voting results of a shareholder meeting has been added to Form 8-K as Item 5.07
- The Form 8-K must be filed within four business days after the end of the shareholder meeting
- If final results are not available, preliminary results must be reported and then the Form 8-K must be amended within four business days after the final voting results are known

Transition Provisions

- The rule changes are effective February 28, 2010
- All Form 10-Ks filed on or after February 28, 2010 must comply with the new rules
- A preliminary proxy statement filed with the SEC by a company with a fiscal year ending on or after December 20, 2009 must be in compliance with the new rules if the company expects to file its definitive proxy statement on or after February 28, 2010

Transition Provisions (cont.)

- If a company with a fiscal year ending on or after December 20, 2009 files its Form 10-K before February 28, 2010, its proxy statement must comply with the new requirements if it is to be filed on or after February 28, 2010
- If a company's fiscal year ends before December 20, 2009, its Form 10-K and proxy statement need not comply with the new requirements even if they are filed after February 28, 2010 and need not comply with any of the Regulation S-K amendments until it files its documents for its 2010 fiscal year-end

Transition Provisions (cont.)

- A company may comply with the new requirements on a voluntary and discretionary basis, except that a company may voluntarily comply with the Summary Compensation Table and Director Compensation Table amendments *only* if it also complies with all of the other Regulation S-K amendments that were adopted and are applicable to the form being filed
- A new registrant must comply with the new requirements in order to have a registration statement declared effective on or after February 28, 2010

Transition Provisions (cont.)

- If a shareholder meeting takes place before February 28, 2010, no Form 8-K is required to report voting results, but can continue to be reported in the next Form 10-K or Form 10-Q, as applicable, using the “Other Information” item if the form is filed on or after February 28, 2010

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