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Small Business Securities Bulletin

A periodic bulletin keeping small businesses informed about current developments in securities law and related matters

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It's been busy in the securities and corporate governance arena lately. First, the Securities and Exchange Commission released its proposed rule regarding stockholder access to the company's proxy materials with respect to director nominations and a rule amendment regarding stockholder proposals addressing director nomination procedures. SEC Chairman Mary Schapiro has stated that the SEC is considering additional disclosure requirements in the board of directors and compensation disclosure areas. Finally, several compensation and corporate governance bills have been introduced in Congress, and even Treasury's Financial Regulatory Reform white paper discusses "principles of compensation."

Proxy Access and Stockholder Proposals Regarding Director Nomination Procedures

On June 10, the SEC released its proposal to adopt new Rule 14a-11 under the Securities Exchange Act of 1934. Rule 14a-11 would implement procedures to allow stockholders that hold a certain percentage of the securities of a public company with a class of securities registered under Section 12 of the Exchange Act (this includes most reporting companies, including any company with a class of securities listed on a national securities exchange) to nominate directors to the company's board using the company's proxy materials (i.e., the proxy card and proxy statement). For smaller reporting companies, stockholders (or a group of stockholders acting together) who are otherwise

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permitted to nominate directors would be able to have their director nominees included in a company's proxy materials if the stockholder or group has owned, for at least one year, at least 5% of the company's voting securities. Such stockholders or groups would be permitted to include in the company's proxy materials nominees equal to the greater of one director or up to 25% of the board. If a company receives stockholder nominees in excess of this threshold, it would include in its proxy materials the nominee(s) of the stockholder(s) that first provided timely notice under the Rule. The proposed Rule, if adopted (which is widely anticipated), would make it easier and less expensive for certain stockholders to engage a company in a contested election.

In addition, the SEC proposed an amendment to Exchange Act Rule 14a-8(i)(8), which allows a company to exclude from its proxy materials a stockholder proposal that "relates to an election for membership on the company's board of directors." Currently, the SEC interprets this rule to allow companies to exclude stockholder proposals that relate to a company's director nomination process. The proposed amendment would narrow the rule so that a company could not omit a proposal by an eligible stockholder (i.e. those who hold the lesser of $2,000 in market value or 1% of the company's securities for one year prior to submitting the proposal) that would amend, or request an amendment to, director nomination or nomination disclosure provisions in the company's governing documents.

More SEC Disclosure Requirements on the Horizon

We understand that the SEC may soon be considering revised disclosure requirements for reporting companies in the following areas:

- Expanding the disclosure requirements with respect to director nominee background and experience, including why the company believes the director nominee is qualified to serve as a director.

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- Disclosure as to how the company, and its board of directors in particular, manages risk, both generally and in the context of setting compensation, including how employee actions are driven by the company's compensation approach and how it relates to risk management.
- Information on the company's compensation policies with respect to all of its employees instead of just its top executives.
- Disclosure as to the board of directors' reasons for its particular leadership structure, such as having a combined Chair/CEO as opposed to an independent director serve as Chair.
- Additional disclosure regarding compensation consultants' conflicts of interest.

We note that we are not aware of the specifics of any of these potential areas of expanded disclosure and that, even if proposed and adopted, some of the new requirements may not apply to smaller reporting companies. Proposals on these matters may be published as early as next month. We will monitor developments in this area and discuss any such developments in future Bulletins.

Legislative Developments

On May 19, Senator Charles Schumer of New York introduced a bill entitled the "Shareholder Bill of Rights Act of 2009." This bill would confirm the SEC's authority to implement proxy access and direct the SEC to establish rules for proxy access in the election of directors for stockholders or a group of stockholders acting together that have beneficially owned at least 1% of a company's voting securities for at least two years before the date of the company's next scheduled annual meeting. The Schumer bill would also implement "say on pay" for all public companies with a class of securities registered under Section 12 of the Exchange Act, requiring a non-binding "stockholder vote to approve the compensation of executives" as disclosed pursuant to the SEC's executive compensation disclosure rules. Such a vote would be required in connection

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with any proxy or consent for a meeting for which the SEC's rules require compensation disclosure, in particular, a company's annual meeting. The bill would also implement a non-binding stockholder vote on compensation to be paid to the principal executive officers of a public company in connection with an acquisition, merger, consolidation, proposed sale or any other disposition.

Companies listed on a national securities exchange (including the NYSE and NASDAQ) or quoted on a national securities association would be subject to additional provisions under the Schumer bill. The bill would require that directors of listed companies be elected annually (in other words, it would prohibit classified boards), and that directors be elected by majority vote, except in contested elections in which directors would be elected by plurality vote. Listed companies would also be required to have an independent board Chair who has never served as an executive officer of the company and establish a risk committee composed entirely of independent directors that would be "responsible for the establishment and evaluation of the risk management practices of the [company]."

Not to be outdone by the Senate, on June 12 Representative Peters introduced the "Shareholder Empowerment Act of 2009." In addition to requiring proxy access and say on pay as well as majority voting in uncontested director elections and an independent board chair (with "independent" being defined in the bill with bright-line exclusions different from those of the national securities exchanges), the Peters bill would:

- Eliminate the ability of brokers to vote uninstructed shares in uncontested director elections (a proposed New York Stock Exchange rule change to eliminate brokers' ability to vote uninstructed shares in uncontested director elections is currently pending at the SEC);
- Require that a compensation consultant retained in connection with negotiating employment or executive compensation agreements be

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independent of the company, executives and directors and report solely to the board of directors. In addition, the company would be prohibited from agreeing to indemnify or limit the liability of compensation consultants;

- Implement the recovery or "clawback" of bonus, incentive and equity payments awarded to executives that were "unearned … owing to fraud, financial results that require restatement, or some other cause;
- Prohibit listed companies from providing severance to a senior executive officer terminated for poor performance; and
- Require the SEC to adopt rules requiring additional disclosure of specific performance targets used to determine compensation for senior executive officers. In this regard the SEC would be required to "consider methods to improve disclosure in situations where it is claimed that disclosure would result in competitive harm to the issuer" including disclosure of past experience with similar target levels or inconsistencies between compensation and other targets, requiring the company to submit a confidential treatment request, or disclosure of the data after it would no longer be competitively harmful.

Meanwhile, Senator Richard Durbin has introduced the "Excessive Pay Shareholder Approval Act" and the "Excessive Pay Capped Deduction Act of 2009" to require a supermajority (60%) stockholder vote to approve, and disallow any federal tax deduction for, "excessive compensation." "Excessive compensation" under the bills is compensation in excess of 100 times the average compensation paid to all of the company's employees.

While these bills may not be enacted in the forms proposed, certainly we expect that proxy access (pursuant to the SEC's proposal) and say on pay in some form are likely to be implemented. Even if not adopted as proposed, we believe these bills are a harbinger of things to come, in other words, SEC reporting companies should be prepared for

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additional corporate governance and compensation legislation and regulation that will be targeted towards them. Again, we will monitor legislative developments in this area and discuss any material developments in future Bulletins.

Other Executive Compensation Developments:

Financial Regulatory Reform

Treasury's "Financial Regulatory Reform" white paper, which proposes a sweeping overhaul of the supervision of the nation's financial regulatory framework and was released on June 17, includes the "Principles of Compensation" that Treasury Secretary Tim Geithner had released on June 10. The Principles of Compensation are a set of broad-based principles aimed at beginning "the process of bringing compensation practices more tightly in line with the interests of shareholders and reinforcing the stability of firms and the financial system." Treasury anticipates that these principles, set forth below, will be "fully integrated into the supervisory process" for financial firms, but they also provide good insight into the administration's thinking and where we may be headed with respect to compensation requirements generally:

Compensation plans should properly measure and reward performance in order to link the incentives of executives and other employees with long-term value creation.

Compensation should be structured to account for the time horizon of risks. Companies should seek to pay top executives in ways that are tightly aligned with the firm's long-term value and soundness, such as requiring executives to hold stock for a longer period of time.

Compensation practices should be aligned with sound risk management. Compensation committees should conduct and publish risk assessments of pay packages to ensure they do not encourage imprudent risk practices.

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Golden parachutes and supplemental retirement packages should be reexamined to determine whether they align the interests of executive and shareholders.

Promote transparency and accountability in the process of setting compensation. Many of the compensation practices that encouraged excessive risk taking might have been more closely scrutinized if compensation committees had greater independence and shareholders had greater clarity.

The white paper also indicates that Treasury will work with Congress to pass legislation implementing say on pay and golden parachute payments in connection with a change in control for all public companies as well as legislation that would require listed companies to have a compensation committee composed of directors who meet increased independence standards, similar to what is currently required for audit committee members pursuant to the Sarbanes-Oxley Act of 2002. The latter proposal would also set independence standards for compensation consultants and outside counsel retained by the compensation committee.

Treasury further contemplates increased compensation disclosure requirements implemented the SEC and a review of compensation practices to monitor how compensation practices affect risk taking. We will discuss Treasury's proposals in additional detail in our July Bulletin.

In response to Mr. Geithner's initial announcement, House Financial Services Committee Chairman Barney Frank stated that Congress should pass legislation that goes beyond the principles outlined by Treasury "and adopt legislation that mandates that the SEC adopt appropriate rules that embody these principles." We expect that any reform in this area that is initially targeted at financial firms will sooner rather than later be expanded to all public companies; with the SEC's involvement, these types of requirements might be imposed on all public companies simultaneously.

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About Me

I am a former SEC attorney who also has prior "big firm" experience. I assist public as well as private companies with compliance with federal and state securities laws, including assisting public companies with their reporting obligations under the Securities Exchange Act of 1934, at competitive billing rates. Please contact me if you would like more information about my practice or to discuss how I can be of assistance to you.

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About Ober|Kaler

Ober|Kaler is a national law firm that provides integrated regulatory, transaction and litigation services to financial, health care, construction and other business organizations. The firm has more than 120 attorneys in offices in Baltimore, MD, Washington, DC and Falls Church, VA. For more information, visit www.ober.com.

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