SEC Adopts New Regulations to Deter Fraudulent Conduct and Excessive Risk Taking

Broader Proxy Disclosure Requirements on Executive Pay

James J. Sabella

The SEC has recently proposed and adopted new regulations to deter fraudulent conduct and excessive risk-taking.

Broader Proxy Disclosure Requirements on Executive Pay

On December 16, 2009, the SEC voted 4-to-1 to adopt broader proxy disclosure requirements forcing public companies to reveal more information about how they pay their executives. The voting comes amid recent public outcry over excessive executive compensation. The expanded executive pay disclosure rules are due to take effect on February 28, 2010, so additional disclosures should be incorporated into annual proxies to shareholders in the Spring. Key provisions of the expanded disclosure rules include:

Broad-Based Pay and Risk Disclosure:

Companies will be required to provide information about their compensation policies for all employees if the policies "create risks that are reasonably likely to have a material adverse effect on the company." The SEC emphasizes disclosure should be specific to the particular situation at each company and should not be generic or boilerplate. Situations that may trigger this additional disclosure requirement include, but are not limited to, cases where a business unit carries a significant portion of the company's risk profile, provides significantly more profit than other business units, or compensates its employees with a different compensation structure than other business units.

Equity Award Values in Summary Compensation Table:

The new rule will require companies to show in a summary table the estimated value of all stock-based awards on the day they are granted. The SEC's 2006 rules had relegated those totals to a separate table that investors often overlook or find hard to decipher.

Enhanced Director and Nominee Disclosure:

Additional annual disclosure will be required for all directors, including director nominees and directors not up for reelection, regarding the particular experience, qualifications, attributes or skills that led the board to conclude that individual should serve as a director as of the time of the filing. The final rules do not specify the particular information that needs to be disclosed to meet these requirements, giving companies flexibility in determining what disclosure is necessary. Companies will be required to disclose whether and how the nominating committee considers diversity in identifying director nominees. The final rules do not offer a definition for diversity, recognizing that companies may define diversity in various ways and should be allowed to define diversity in ways that they consider appropriate for this disclosure.

In addition, the proposal requires disclosure of all other public company boards served on the by the director in the last 5 years (rather than only current board memberships) and disclosure of any legal proceedings from the last 10 years (rather than the last 5).

Board Leadership Structure:

Companies will be required to discuss their current board leadership structure and why this structure is best for the company. In particular, companies must discuss whether or not the CEO and Chairman roles are held by the same person and why this structure was chosen. If the CEO and Chair roles are not split, companies must disclose if they have a Lead Independent Director and the specific roles and responsibilities of that position.

Board's Role in Risk Oversight:

Companies will be required to provide additional information about the board of director's role in the company's risk oversight. Disclosure should detail specific processes, roles, and responsibilities of the board in connection with monitoring and managing the company's risk.

Compensation Consultant Fee Disclosure:

Enhanced disclosure will be required when a consultant or its affiliate provides executive or director compensation advice and other consulting services to the company, if fees for the non-executive compensation services exceed $120,000. Input by the management must also be disclosed in the decision to engage the executive compensation consultant for non-executive compensation consulting services. However, discussion of the nature and extent of the additional services will not be required, even if the threshold value is met. Fees paid to a consultant for additional services will not be required if the board has its own consultant.

Shareholder Voting Results:

The requirement to report shareholder voting results is changed from 10-Q and 10-K filings to 8-K filings. This will increase the timeliness of the delivery of voting results to within 4 business days of the vote. For contested elections where voting results are not finalized within 4 days, preliminary voting results must be disclosed in the 8-K filing.

Proposed New Proxy Access Rules

On June 18, 2009 the SEC proposed rules to enable certain shareholders to place their nominees for director on the company's proxy statement. For most companies, if a shareholder nominates a director he or she must finance a solicitation campaign and distribute proxies to shareholders, which can be prohibitively expensive. Under state law, currently, a company can adopt bylaws that require the company to place shareholder-nominated directors on the company's proxy statement, however, very few companies have such a bylaw. Furthermore, while Rule 14a-8 requires a company to place certain shareholder proposals on its proxy statement, including proposals to amend a company's bylaws, Rule 14a-8(i)(8) allows companies to exclude proposals that seek to allow shareholders to nominate directors on the company's proxy statement.

The proposed rule would change this regime in two important respects. First, it would require a company to place in its proxy statement the nominees of a shareholder or group of shareholders who own between 1 percent and 5 percent of the company, depending on the company's size. Such nominees must be independent of the company. Second, it would require companies to include shareholder proposals in its proxy statement that would give shareholders broader access to the company's proxy statement to nominate directors.

One important limitation is that shareholders who wish to effect a change in control of the company may not rely on the new rule. A company will only be required to include in its proxy statement no more than one shareholder nominee or the number of nominees that represent 25 percent of the company's board, whichever is greater.

The proposed rule favors requires nominating shareholders to hold the required amount of company stock for one year and continue to hold such stock through the date of the annual meeting in which shareholders vote on the nominee.

The proposed rule also enables shareholders to make limited communications with each other to form a group without filing a proxy statement, which is required when making other types of solicitations. These communication may include, among other things, a brief statement regarding the potential nominee or, if there is not yet a specific nominee, the characteristics of the nominee that the shareholder intends to nominate. Furthermore, the communications must be filed with the SEC

The proposed rule also allows shareholder to solicit votes in favor of a nominee without filing a proxy statement. Such solicitations must be filed with SEC, state the identity of the nominator and their holdings in the company, and state that the nominee will be included in the company's proxy statement. However, the solicitation may not seek the power to act as proxy.

Disclosure Requirements Concerning Climate Change

On January 27, 2010, the SEC issued an interpretive release ("Interpretive Release") identifying areas where current SEC rules may require disclosures related to climate change. Regulation S-K requires certain disclosures in a company's SEC filings. For example, Item 101(c)(1)(xii) of Regulation S-K requires disclosure of "the material effects that compliance with Federal, State and local provisions . . . relating to the protection of the environment . . . may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries." Item 103 of Regulation S-K requires disclosure of legal proceedings against a company. Item 303 of Regulation S-K is known as "Management's Discussion and Analysis of Financial Condition and Results of Operations. It provides "a narrative explanation of a registrant's financial statements that enables investors to see the registrant through the eyes of management."[1] The Interpretative Release states that these disclosure requirements may require a company to discuss the effects of climate change in the following areas:

Impact of Regulations: A company must disclose if expected regulation to reduce carbon emission will affect the company's business.

International Accords:

A company must disclose if international accords relating to climate change will affect the company's business.

Indirect Consequences of Regulation or Business Trends:

The Interpretive Release States: "Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for registrants." Examples of such risks or opportunities include decreased demand for goods that cause emit greenhouse gasses or increased demand for alternative fuels.

Physical Impacts of Climate Change:

A company must disclose whether it faces risk because of climate change caused by global warming, including floods and hurricanes.

Investment Advisor Custody Rules

On December 30, 2009, the SEC amended rules under the Investment Advisor Act of 1940 in order to deter fraudulent conduct of investment advisors. In most cases, investment advisors are required to keep client funds with "qualified custodians." Under Rule 206(4)-2, investment advisors had the option of having the custodian submit quarterly reports directly to the client or undergoing a surprise inspection by an independent public accountant annually. Under the new rule, the custodian must submit quarterly reports directly to the client. This helps ensure that investment advisors are not misappropriating client funds.

Under the old rule, an investment advisor was required to send a notice when the investment advisor opened a custodial account for a new client. Under the new amendment, that notice must have a legend alerting the client to compare the custodian's reports with the investment advisor's reports.

Where the investment advisor retains custody of client funds, amendment to Rule 206(4)-2 requires the investment advisor to submit to a surprise annual inspection by an independent public accountant. This requirement does not apply to investment advisors who have control of client funds for the sole purpose of deducting advisory fees.

In addition to the surprise audit, when an advisor or a person related to the advisor maintains client funds the advisor must commission a report from an independent public accountant to assess the internal controls of the advisor or related party.

Also, the amended rules require increased reporting by the investment advisor to the SEC. For example, an investment advisor must disclose all related broker-dealers and indentify which of those broker-dealers serve as custodians for client funds. In addition, an investment advisor must disclose whether the investment advisor or a person related to the investment advisor has custody of client funds and the dollar amount of those client funds.

Regulations on Short Selling

Naked Short Selling

Naked short selling is the practice of selling shares short without first borrowing the shares. As a result, there is a risk that a naked short seller will fail to deliver stock as promised. Naked short selling, which has the potential to generate unlimited sell order, can increase the supply of stock thereby driving down prices. Such naked short selling has been blamed for speeding the demise of Bear Stearns and Lehman Brothers.[2] On July 27, 2009, the SEC adopted permanent rules that imposed penalties on clearing firms that do not purchase or borrow shares to close out transactions in which the short seller failed to deliver stock within one day after the failure. In addition, the SEC is working with self-regulatory organizations to increase disclosures related to naked short selling.

Short Selling

On February 24, 2010, the SEC adopted rules to regulate short selling. Now, if a stock declines more than 10% short selling would only be permitted if the "price of the security is above the current national best bid."[3] The purpose of this rule is to prevent short-sellers from driving down the price of securities when it is falling dramatically.

Still, this new regulation is not as strong as the so-called up-tick rule, repealed in 2007, which only allowed the short sale of stocks where the price of the stock in the most recent trade was higher the price in the previous trade.

Regulation of Sellers of Municipal Bonds

Responding to an increase in fraud in the sale of municipal bonds, the Municipal Securities Rulemaking Board ("MSRB"), which regulates dealers who deal in municipal bonds, recently amended its rules. To prevent dealers of municipal bonds from being awarded underwriting business for political donations, on December 4, 2009, MRSB announced proposed changes to Rule G-37 and Rule G-8 to require that dealers disclose contributions to bond ballot campaigns and maintain books and records concerning those donations. Bond ballot campaigns are defined as "any fund, organization or committee that solicits or receives contributions to be used to support ballot initiatives seeking authorization for the issuance of municipal securities through public approval obtained by popular vote."

On November 17, 2009, MSRB amended Rule G-11, which required a syndicate of underwriters of municipal bonds to make certain disclosures, to

(1) apply the rule to all primary offerings, not just those for which a syndicate is formed;

2) require that all dealers (not just syndicate members) disclose whether their orders are for their own account or a related account; and (3) require that priority be given to orders from customers over orders from syndicate members for their own accounts or orders from their respective related accounts, to the extent feasible and consistent with the orderly distribution of securities in the offering, unless the issuer otherwise agrees or it is in the best interests of the syndicate not to follow that order of priority.

1 Release No. 33-8350 (December 19, 2003) [68 FR 75055].

2 See Gary Matsumoto, *Naked Short Sales Hint Fraud in Bringing Down Lehman*, Bloomberg (March 19, 2009).

3 Press Release, SEC, SEC Approves Short Selling Restrictions (February 24, 2010).

4 MSRB, Proposed Rule Change Consisting of Amendments to Rules G-8, G-9 and G-11, a Proposed Interpretation of Rule G-17 Regarding Priority of Orders, and the Deletion of a Previous Rule G-17 Interpretive Notice (November 18, 2009).

Grant & Eisenhofer