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# The New Enhanced Proxy Disclosure Rules: Putting More "A" and Less "D" in CD&A

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As the SEC staff has acknowledged, the new enhanced proxy disclosure rules — requiring information about board qualifications, leadership and oversight — are the latest installment in the ongoing effort to push companies to provide more "analysis" and not just "discussion" in their disclosures. They are also the latest installment in what some characterize as the SEC's ongoing effort to regulate corporate governance by the imposition of targeted disclosure obligations, notwithstanding that the SEC lacks a clear mandate to regulate corporate governance, an area traditionally the province of state law's more laissez-faire approach.

In crafting the new required disclosures about board qualifications, leadership and role in risk oversight both during the rapidly approaching 2010 proxy season, and also in preparing the Compensation Discussion and Analysis (CD&A) in current filings, boards and their advisors should heed the SEC's not-so-positive feed back with respect to CD&A disclosure compliance. In that context, the SEC has lamented that "far too many companies continue to describe — in exhaustive detail — the framework in which they made the compensation decision, rather than the decision itself. The result is that the "how" and the "why" get lost in all the detail."[1]

As the deputy director of the Division of Corporate Finance admonished:

> A company's analysis of its . . . decisions should present shareholders with meaningful insight into its . . . policies and decisions, including the reasons behind them. Where analysis is lacking, shareholders are often left with a pages-long discussion that is heavy on process but does not explain the reasons why.

[1] Speech by Shelley Parratt Deputy Director, Division of Corporation Finance U.S. Securities and Exchange Commission: "Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010," ("SEC Disclosure Expectations for 2010″) November 9, 2009, available at http://www.sec.gov/news/speech/2009/spch110909sp.htm.

The SEC staff has made plain that the disclosure concerning the "reasons why" will also be a central focus with respect to the new corporate governance disclosure required by the enhanced proxy disclosure rules.[2]

So how should boards and management and their advisors make certain that their company's disclosures meet the letter and the spirit of the new rules? As demonstrated by the SEC staff's response to CD&A disclosure, the "what," *i.e.*, the purely factual and the process parts, is not the problem. Instead, describing the "why" (e.g., the reasons and rationale), seems to be the hard part.

Why is that? Probably because, boards, and probably more accurately their advisors, aren't used to saying "why." This may be due to habit or reflexive fears about being too specific or revealing too much or being picked apart for perceived mistakes or omissions by shareholder activists or plaintiffs or SEC enforcement or some combination of these or other more circumstantial factors. It may also be due to the fact that the advisors who craft the disclosures aren't always in the room to hear the deliberations or the reasons, but are left to detail the process.

What is of concern to the SEC staff is that for whatever reason, issuers and their advisors tend to focus on implementing and then describing structures and frameworks and constructs with the intercession of committees and experts, all in an effort to show that the "how" part was very deliberate and well thought out. That's all good (but quite often, as the SEC lamented, overdone) but it still doesn't get to the "why".

Why is the "why" so important? For several reasons.

First, and most obviously, because the "why" is what activist investors and good governance watchdogs have said that they want in order to hold boards and management accountable. The "why" is thus also what the SEC, under pressure from investors particularly in the context of the recent financial crisis, wants to enable the investors to know. As the SEC stated, the rules were adopted in response to

> " investors' . . . increasing[] focus[] on corporate accountability and . . . expressed . . . desire for additional information that would enhance their ability to make informed voting and investment decisions. The disclosure enhancements . . . respond to this focus [by seeking to] significantly improve the information companies provide to shareholders. We believe that providing a more transparent view of these key risk, governance and compensation matters will help shareholders make more informed voting and investment decisions."[3]

Second, the "why" is required because if all that is disclosed is the structural process and the ultimate decision and not the reasons (pro and con) that underlie the decision, then investors may

[2] Comments of Shelley Parratt Deputy Director, Division of Corporation Finance U.S. Securities and Exchange Commission at NACD Capital Area Chapter Conference, January 2010.

[3] Release Nos. 33-9089; 34-61175 [17 CFR PARTS 229, 239, 240, 249 and 274] ("Adopting Release"); see also Release No. 33-9052 (July 10, 2009) [74 CFR 35076] ("Proposing Release").

not have sufficient meaningful additional information to enable them to assess the board's decision. Disclosure of a process or procedure may tell investors that the issue was discussed and that advice and information was considered but provides no insight into which factors (pro and con) were deemed important in reaching the decision. For example, did the board re-nominate a director or continue to have the CEO serve as Chairman because he is well liked by management or the board? Because his name is on the door? Because he has been at the Company forever? Probably not! Certainly, not only for such reasons. But without disclosure of at least some of the most important of the board's actual reasons for determining why a director is qualified or why the CEO should also be the Chair, it may be less than apparent to investors why the decision is sound. And it can only help if reasons are provided beyond those that may be inferred from the biographical information that issuers typically provide.

Third, it is safe to assume that the SEC staff's hope is that the new disclosure requirements (all that the SEC can really regulate) will prompt better governance and decision-making. If, on examination, the board, management and/or their advisors are concerned that the "why" isn't good enough, that conclusion should prompt the board to re-examine its decisions. Are there in fact other legitimate reasons for the decision? If not, changes or improvements may well be in order If the status quo, on reflection, presents unacceptable risks or is not "best practices", the board should consider what changes might be made or what counterbalancing mechanisms are or can be put into place.

If all that is disclosed is the mechanistic procedures or abstract constructs that provide the framework for decision-making, then the quality of the deliberative process will not be apparent in the company's disclosures. Yet it can be presumed that in promulgating these disclosure rules the SEC, whose jurisdiction does not permit it to regulate governance, was hoping to encourage better governance through the back-door of requiring the reasons behind governance policies and practices to be disclosed. Without disclosure of those reasons, the beneficial self-examination process presumably meant to be prompted by the disclosure rules is lost. And where the deliberative process is in fact rich and considered, as is usually the case, unless the board shows at least some of its work, it will not get as much credit for the decisions it describes.

Fourth, and further to the back-door governance-regulation-through-disclosure requirements point, it can be presumed that the hope is that these new (and any) requirements will not only prompt better decision making, but also help to prevent bad decisions from being made. All disclosure rules are premised on the idea that "sunlight is the best disinfectant."[4] If the reasons why a director has been re-nominated or the reasons the CEO is the Chair or the quality of board's risk oversight isn't good enough to tell the shareholders they are probably not good enough. And, of course, if the reasons aren't good enough, the right answer can't be not to tell the shareholders!

[4] Louis D. Brandeis, "What Publicity Can Do," Other People's Money, chapter 5, p. 92 (1932). First published in Harper's Weekly, December 20, 1913 ("Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.")

There are many good reasons why the board and its advisors shouldn't resist saying why — at least to a point.

Responsible boards should not resist disclosing the usually very good reasons for their usually very good decisions. If the reasons are good — get them out there! Just tell it like it is. There should be no concern about liability if you have any good justifications. Even if your reasons are less than perfect, even if the board has overlooked something and even if the omission is obvious in hindsight, there is no cause of action for less-than-perfect decisions made in good faith that have some conceivable rational basis — a low bar which is well below that of most every decision most boards will ever make.

And remember that telling it like it is means just that. Those who are crafting the disclosure must take care not to try to improve upon the decision making process after the fact. Instead, advisors should be enlisted to help make certain that directors' process and deliberation are robust and establish a record in broad brush of the most important reasons (pro and con) for the board's decisions. This isn't to say, of course, that every reason for good decisions needs to be highlighted or weighted where plenty of good reasons exist and are considered and disclosed. Instead, the general nature of the considerations and whether they generally weighed in favor of the decision or not (but not the relative weights) might be described.

Of course, the practical problem is that decision making is not a simple process. A board is comprised of individuals who have different viewpoints and often there are many individual and conflicting reasons. In drafting the proxy statement, one is not expected to interview each board member and walk through their thought process. Rather, the record should summarize in a general way the important considerations (pro and con) that ultimately resulted in the business judgment — that a director is qualified, that the board's leadership structure is appropriate and that the risk oversight mechanisms the board has put in place are believed to be adequate.

It is true that if shareholders don't like a decision or the reasons underlying the decision they can sell their shares or vote those shares against the board the next time around if the decision goes south or sour. Theoretically, shareholders are more likely to sell or withhold if they disagree with the decision but have no idea why the board did what it did. If the board tells the shareholders the good reasons for their decisions, informed by their judgment and experience and that of their advisors, there is no reason to expect the shareholder response would be worse than if they were forced to speculate about the board's rationale.

Of course, some will argue that more information potentially gives potential plaintiffs' lawyers more to poke at, but plaintiffs' lawyers won't go away if there is a corporate calamity or challenge to control just because you said less. In fact, proper disclosure can serve as a defensive document. Where disclosure is sober, straightforward and cautious, it can actually aid in defending against claims of false or misleading statements or omissions — even when the future misfortunes were not foreseen.

And any impulse to be circumspect about decision making premised on a “father-knows-best” paternalism, or worse, a desire to stay on despite unpopular decisions, are sentiments that no longer have validity in today’s corporate world.

Instead, by going through the process of disclosing the reasons for their decisions, boards may seek additional information and consider alternatives and may in some circumstances reach a different or better decision. The knowledge that the decision making process will now be a matter of scrutiny, will also make boards more likely to consider, when considering disclosure, how shareholders (and shareholder activists, the SEC and the markets) will react. Are we perpetuating a practice that has caused problems at other companies? If so, are our risk mitigation strategies sufficient and how will we describe them? Is our policy not “best practices” from the point of view of the proxy advisors and will that hurt us? What changes should and can we make — if any?

All of this is, by the way, exactly the sort of good governance process that the SEC in promulgating its disclosure requirements can be presumed to have hoped to promote. All of this is good for the board, good for the company and good for the shareholders — although it may not be good for board participants who aren’t doing their jobs as well as they should.

The point of all this is that in figuring out how to comply with the new rules, don’t lose the forest or the trees. The disclosure is not just about the process the board puts in place. What is as or more important are the reasons that come out of that process that lead to the board’s decision. All the board needs to do is disclose what it decided and some of the more important reasons it considered, i.e., why (not necessarily even how) it decided what it did.

The unspoken issue is that there are some things the board may not want to say. And those are the things that the rules probably mean to spotlight for directors to examine and fix. If the board does that, its disclosure will describe better and/or more reasoned governance decisions. If the board doesn’t reexamine and fix what needs fixing, then its shareholders will judge. If the board isn’t transparent in explaining its decisions either way, then both the shareholders and the SEC will demand more. As the staff has already warned: “When a company explains its . . . decision-making processes but does not explain why it made the . . . decisions it made, we will ask for enhanced disclosure of the analysis,”[5] — in other words “why”.

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[5] See SEC Disclosure Expectations for 2010, supra at n.1.