The New Enhanced Proxy Disclosure Rules – Ready, Set, Change and NOW

Posted by Charles M. Nathan, Latham & Watkins LLP, on Wednesday April 28, 2010

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The SEC’s new enhanced proxy disclosure rules, requiring disclosure concerning (1) board leadership structure and qualifications, (2) risk and risk oversight and (3) compensation issues, were adopted in response to “investors’ . . . increasing[] focus[] on corporate accountability” in the wake of the financial crisis. But almost as important as the substance of the rules, well documented elsewhere, are the underpinnings of the new requirements – the SEC’s un- or understated objectives in promulgating the new rules. In order to assure compliance with both the letter and the spirit of the rules, practitioners should be mindful of the repeatedly denied but fairly obvious governance “best practices” agenda that animates the rule making. Moreover, although the disclosures may not be required until your next proxy statement, the disclosure requirements

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2 The rules require enhanced disclosure concerning “compensation policies and practices that present material risks to the company; stock and option awards of executives and directors; director and nominee qualifications and legal proceedings; board leadership structure; the board’s role in risk oversight; and potential conflicts of interest of compensation consultants that advise companies and their boards of directors.” Adopting Release at 1. See also id. at 98: rules require additional disclosure concerning “compensation policies and practices, and the impact on risk taking; director and nominee qualifications; board leadership structure; the potential conflicts of compensation consultants; and . . . executive compensation . . . .”

3 “[D]uring the past few years, investors have increasingly focused on corporate accountability, and have expressed the desire for additional information that would enhance their ability to make informed voting and investment decisions. . . .” Adopting Release at 98.

4 The Adopting Release states that “[t]he 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.” Adopting Release at 5. The rules respond to investors’ “expressed . . . desire for additional information that would enhance their ability to make informed voting and investment decisions.”
assume that a process has occurred which can then be described. Accordingly, reassessment and reaffirmance and/or change of the targeted governance policies and practices cannot start too soon.

First, there can be no serious doubt that the rules reflect an expectation that boards will re-examine and in many cases improve their corporate governance policies and practices. In this respect, the new rules are the latest installment in what some characterize as the Commission’s ongoing effort to regulate corporate governance by the imposition of targeted disclosure obligations, despite the fact that the SEC lacks a clear mandate to regulate corporate governance (and denies any such intent), an area traditionally the province of state law’s more laissez-faire approach.

While the SEC disclaims any intent to “influence” or “steer” any particular governance structure or policy, insisting it is sticking to its disclosure mandate, the commentary in the Adopting

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5 See “SEC Press Release,” discussed supra at n. 1. SEC Commissioner Kathleen Casey, the only commissioner to vote against the new rules, posed the general question of whether these or any proposed disclosure requirements are “policy-neutral,” or likely to have a “coercive effect” and whether they are meant merely to “elicit information that informs investors,” or, instead, “designed to influence companies’ governance practices to achieve policy objectives that are unstated, and/or that fall outside the SEC’s core regulatory mission, and . . . core competency, of investor protection.” Statement of Commissioner Casey.

6 In the wake of Sarbanes-Oxley, Vice Chancellor Stine expressed the hope that the federal government would leave internal corporate governance to Delaware and “stay in its lane.” Vice Chancellor Leo E. Strine, Jr., “The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face,” DELAWARE JOURNAL OF CORPORATE LAW, Vol. 30, No. 3, pp. 673, 685 (2005). Well before the new rule making, the Vice Chancellor stated that “[w]hat will be more troubling is if the federal government continues to veer out of its traditional lane in the American corporate governance system.” Id.

7 See pp. 6-8, infra.

8 Delaware law is generally enabling, rather than prescriptive, regarding the management of the business and conduct of the corporation’s internal affairs. As Vice Chancellor Strine explained: “Delaware corporation law governs only the internal affairs of the corporation. In that sense, our law is a specialized form of contract law that governs the relationship between corporate managers—the directors and officers—of corporations, and the stockholders. Consistent with a contractarian vision, our statute is, by design, a broad enabling one that permits and facilitates company-specific procedures. . . . [T]he Delaware approach to corporate law keeps statutory mandates to a minimum. And even some of the mandatory terms are subject to being overridden through charter and bylaw provisions [giving] corporate planners tremendous power [including the ability] to use the charter—the equivalent of the corporate constitution—to vary otherwise mandatory terms.” Vice Chancellor Leo E. Strine, Jr., “The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face,” DELAWARE JOURNAL OF CORPORATE LAW, Vol. 30, No. 3, pp. 673, 674 (2005).

9 The SEC has stressed the difference between setting governance standards by which directors will be measured and held accountable versus requiring more transparency about governance through disclosure to enable investors to assess governance policies and to hold directors and management more accountable:

   “Good corporate governance is a system in which those who manage a company — that is, officers and directors — are effectively held accountable for their decisions and performance. But accountability is impossible without transparency. By adopting these rules, we will improve the disclosure around risk, compensation, and corporate governance, thereby increasing accountability and directly benefiting investors.”

10 As Commissioner Casey, the sole dissenter on the Commission, put it: “issuer disclosure is the lifeblood of our capital markets, and the Commission fulfills its most fundamental mission when it acts to improve its disclosure regime in order to enhance investors’ ability to analyze issuers’ leadership and financial performance for the purpose of informing their voting and investment decisions.” As discussed below, however, the commissioner was concerned that certain aspects of the rulemaking went beyond this purpose and instead would have the effect of influencing governance policy and interfering with board judgment.

Release itself belies the claimed neutrality. Eighty pages in, (in case you don’t get that far) the
Adopting Release acknowledges that “[t]he new disclosure may” have the “benefit” of “also
courage[ing] the board and senior management to examine and improve” governance policies
and structures.  

Second, the new rules are also the latest installment in the Commission’s ongoing effort to push
companies to provide more “analysis” and not just “discussion” in their disclosures. In other
words, once the board examines and evaluates and potentially changes its governance
structures, or decides not to, the SEC staff expects that the disclosure will explain not just “what”
the board decided, or “what” process it employed, but “why” it decided as it did.

In crafting the new disclosures, practitioners ignore these expectations at their peril. While the
SEC cannot mandate a particular governance process or policy (as it recognizes throughout the
Adopting Release), the new rules certainly will require boards (1) to reconsider and re-evaluate
existing policies and practices (or the lack thereof) targeted by the disclosure rules, and (2)
decide whether changes are necessary, and (3) whether changes are made or not, explain the
reasons “why.” An unexamined process, an unexplained decision concerning governance matters
covered by the rules, a failure to provide detail or the drafting of boilerplate will not suffice.

This article will first further establish and assess the coercive (not necessarily in a bad way) effect
(for better or worse) of the disclosure requirements in pushing companies to examine and
perhaps change their governance policies. Having then established that the SEC expects a
deliberative process examining governance policy sufficient to enable the company to provide a
reasonably detailed description of “why” the board reached its governance decisions, (not just
“what” the decisions are), the article will then (1) explore possible reasons that it’s difficult (or
undesirable) to explain “why,” and (2) conclude with a “how to” section providing some strategies
for facilitating board deliberations and drafting compliant disclosure that provides a better sense

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11 Adopting Release at 80 -82. See also id. at 43, 77 and discussion at pp. , infra.
Compare the statement that the new rules are “intended to provide investors with more transparency about the
company’s corporate governance, but are not intended to influence a company’s decision regarding its board leadership
structure,” with the later concession that “[a]lthough the amendments are not intended to drive behavior, there may be
possible benefits” which “could potentially improve governance” and “may also improve the board’s decision-making
process.” Adopting Release at 43, 79-82. See also pp. 6-8, infra.
12 This “too little analysis” point has been a hot button for the SEC in connection with the recent CD&A
disclosure rules. Speech by Shelley Parratt, Deputy Director, Division of Corporation Finance, U.S. Securities and
Disclosure Expectations for 2010”). The staff has made plain that disclosure concerning the “reasons why” analysis
describing why boards have made certain governance decisions will also be a central focus with respect to the new
corporate governance disclosure required by the enhanced proxy disclosure rules. Comments of Shelley Parratt Deputy
Director, Division of Corporation Finance, U.S. Securities and Exchange Commission at NACD Capital Area Chapter
Conference, January 2010 (hereinafter, “Parratt NACD Comments”).
13 Id.
of “why” the company’s governance decisions, policies and procedures – whatever they are – are what they are.

**Governance Regulation Through the Backdoor of Disclosure?**

Notwithstanding the repeated disclaimers of any intent to “influence” or “drive” behavior or governance policies, it is plain that the SEC hopes that its new disclosure requirements (again, all that the SEC can really regulate) will have the side benefit of prompting better governance and decision-making. While the SEC repeatedly states that the new rules are not intended to mandate any particular governance regime, some of the commentary in the Adopting Release expresses clear preferences for policies that approximate best practices.\(^{14}\) This professed neutrality yet obvious policy preference is evident with respect to each element of the new disclosure.

**Board Leadership Structure**

- The Adopting Release states that the new rules are “intended to provide investors with more transparency about the company’s corporate governance, but are not intended to influence a company’s decision regarding its board leadership structure.”\(^{15}\)

- The Release later concedes: “Although the amendments are not intended to drive behavior, there may be possible benefits if a company re-evaluates its leadership structure or the board’s role in risk oversight and decides to make changes as a result.”\(^{16}\)

**Executive Compensation**

- The Adopting Release states that “the amendments are not intended to steer behavior” but only to make “changes in the way that executive compensation is represented . . . .”

- The Adopting Release later concedes that “changes in the way that executive compensation is represented . . . and other new, compensation-related disclosures may indirectly lead boards to reconsider pay structure, potentially changing the amount of pay in some cases.”\(^{17}\)

- The Release further predicts that “[t]he new disclosure may also encourage the board and senior management to examine

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\(^{14}\) Id. at 77.

\(^{15}\) Id. at 81-82.

\(^{16}\) Id. at 43.
and improve incentive structures for management and employees of the company.

- The Release concludes that
  “These benefits [e.g., improved incentive structures] may also lead to increased value to investors.”\(^\text{18}\)

Diversity Policy

The disclaimers concerning the lack of intent to influence diversity policy are followed by a particularly pointed (and extended) discussion of why a diversity policy is such a good thing:

- The Adopting Release’s discussion of diversity policy disclosure, also starts with the formulaic
  “[a]lthough the amendments are not intended to steer behavior . . .

- The Adopting Release then points out the myriad benefits of adopting a diversity policy including that
  - “[D]iversity policy disclosure may also induce beneficial changes in board composition.”
  - “A board may determine, in connection with preparing its disclosure, that it is beneficial to disclose and follow a policy of seeking diversity.”
  - “[A] diversity policy may encourage boards to conduct broader director searches, evaluating a wider range of candidates and potentially improving board quality.”
  - “To the extent that boards branch out from the set of candidates they would ordinarily consider, they may nominate directors who have fewer existing ties to the board or management and are, consequently, more independent.”
  - “To the extent that a more independent board is desirable at a particular company, the resulting increase in board independence could potentially improve governance.”
  - “In addition, in some companies a policy of increasing board diversity may also improve the board’s decision-making process by encouraging consideration of a broader range of views.”\(^\text{19}\)

\(^\text{18}\) Id. at 79.
\(^\text{19}\) Id. at 80.
It strains credulity that this testimonial in favor of diversity policies, and the other positive statements about best practices included in the Adopting Release does not express a policy preference. While the Adopting Release purports to be policy-neutral the expressed “benefit” of “potential change” and “improvement” reads as if it is drawn from a best-practices good governance manual.

The objections to the rule making, particularly with respect to diversity policy underscore the governance-policy-through-the-back-door-of-disclosure point. Thus, Commissioner Casey, echoing concerns of many commenters, worried that aspects of the new rules, specifically the “director qualification” and “diversity” disclosure rules were coercive and “encroach[ed] on the decision making authority of boards of directors,” "unduly intruded into boards’ decision making process,” and, in some respects, actually “undercut[] investor understanding of how companies compose their boards.” The objections are further evidence that these new governance disclosure rules will require reassessment and explanation of governance practices and not just a description of the policies and practices already in place.

In reality, however, the new rules are not materially more coercive than other SEC disclosure rules, particularly those that came out of Sarbanes-Oxley or even the recent CD&A pronouncements. All disclosure rules are premised on the idea that “sunlight is the best disinfectant.” If forced to look at governance issues (the financial expertise of audit committee members under SOX, for example), companies whose policies significantly diverge from best practices may consider making changes before making disclosure. That’s how all disclosure rules work – by assuming that issuers would rather “shape up” than confess to practices and policies that fall far short of “best.” There is the expectation (if not the empirical proof) that moving towards best practices will potentially improve board governance and decision making, including by helping to prevent ill-considered or unconsidered decisions from being made (by an audit

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20 The Adopting Release states that “[i]n general, the commenters supported the objectives of the proposed new requirements.” Adopting Release at 1. The public comments received by the SEC are available at http://www.sec.gov/comments/s7-13-09/s71309.shtml.

21 Id.

22 Commissioner Casey’s criticism that “rules require companies . . . to justify their selection of board nominees based on criteria determined by the Commission” seems overstated since there are no such criteria set forth in the Adopting Release. Id. (emphasis added). Moreover, the commissioners’ criticism that “the requirements relating to specific diversity policies and their implementation and effectiveness discourage [a more appropriate] holistic view, in favor of a person-by-person approach or a status-based perspective,” also is difficult to square with the actual rule making which, as Commissioner Casey otherwise acknowledges and commands does not define diversity. In fact the rule making requires disclosure concerning implementation and assessment of diversity policies only to the extent a stated policy exists. As a consequence, some practitioners are already advising boards not to adopt a diversity policy so that there is nothing to disclose. It does seem likely, however, that the rule making on this topic may embolden or empower (depending on your point of view) governance activists to push for more diversity on corporate boards.

23 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.”)

24 Of course, the exchanges can and do adopt rules implementing best practices; for example, the New York Stock Exchange and FINRA now require both an audit committee and a financial expert on every listed company’s audit committee although neither is required under Delaware law.
committee member with no financial expertise, by a compensation committee that does not have truly independent consultants, by a board whose membership is not diverse by any definition.

Not a neutral rule making process. But not a particularly revolutionary one since most companies are already moving in the direction of best practices. And in no event an out-of-the-ordinary rulemaking process by any stretch.

Like it or not, however, it is clear that the governance-through-the-backdoor of disclosure regulation criticisms have a valid basis. It is also clear that disclosure under the new rules that is not proceeded by an examined and considered review of those aspects of governance targeted by the new rules will not fly. Nor, as discussed below, will any boilerplate, generalized discussion of the board’s decision and decision making comply. Instead, the disclosure must explain “what” and “how” in some detail, but more importantly, must get to the “why.”

Tell Me “Why” – Or “More ‘A” and Less ‘D”

The SEC staff has made plain that it expects companies to explain in some detail the governance decisions targeted by the new disclosure rules -- whether any policy changes are made or not. The Staff has advised boards and their advisors to heed the not-so-positive feedback with respect to the lack of “A” and the fact of too much “D” in registrants’ CD&A disclosures. In that context, the SEC staff 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.”

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.

The staff has stated that the “reasons why” analysis describing why boards have made certain governance decisions will also be a central focus with respect to the disclosure required by the new rules. The Adopting Release also makes clear that generalization and generic disclosure will not be acceptable, emphasizing that “companies must assess the information . . . in light of the company's particular situation. Thus, for example, we would not expect to see generic or

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26 Id.
27 Parratt NACD Comments
boilerplate disclosure that [policies] are designed to have a positive effect, or . . . may not be sufficient to [achieve some general corporate purpose].”

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 and formulistic process, 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”.

If all that is disclosed is the structural process and the ultimate decision and not at least some of the reasons (pro and con) that underlie the decision, then investors may not have sufficient meaningful additional information to enable them to assess the board’s decision making about governance policy when making their own investment and voting decisions. While disclosure of a process or procedure may tell investors that the issue was discussed and that advice and information was considered, such discussion provides no insight into which factors (pro and con) were deemed important in reaching the decision. There is not enough to tell them “why.”

Why else the SEC worries you won’t get to the “why”.

The past CD&A experience (and the more general effort to improve upon boilerplate disclosure that is almost as old as the disclosure regime) is not be the only reason that the SEC may have some anticipatory anxiety about the quality of the disclosure likely to be provided under the new rules. Even as the staff warned against boilerplate in the CD&A context, many issuers and advisors warned of more of the same in response to the new rulemaking. Ironically, or predictably, depending on your point of view, some commenters objected to these new rules meant as another effort to get behind the “boilerplate” on the ground that they were likely to result in just more boilerplate, instead of any meaningful disclosure that would be useful to investors. Moreover, most of these objections were not put forward in the interest of improvements to the proposed disclosure rules or in proposing suggestions as to how the rules could evince more or

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28 Adopting Release at 16 (providing illustrative examples of compensation risk disclosure but warning that company-specific disclosure must be crafted).

29 The Adopting Release notes that “[m]ost companies, law firms and bar groups opposed [at least portions of the proposal due to] [c]oncerns that the proposed revisions would lead to boilerplate disclosures and information that would not be meaningful to investors” and that existing disclosure documents were “already long and the proposed amendments would add length without a corresponding benefit to shareholders.” Adopting Release at 10-11. “Many of these commenters believed that the proposed amendments were too vague and would likely elicit boilerplate descriptions of a company’s management hierarchy and risk management that would not provide significant insight or meaning to investors.” Id. at 41. Another concern expressed by commenters was that . . . disclosures provided under the proposed amendments would likely be boilerplate that could give investors a false sense of comfort regarding risk and risk-taking.” Id. at 10. The Adopting Release also noted that “[c]oncerns were also expressed that risk management, risk-taking incentives and related business strategy are complex subjects that could not be adequately analyzed . . . without adding voluminous text to an already lengthy proxy statement.” Id.
better information. Instead the “just more boilerplate” concern was voiced as a reason for not implementing any new disclosure rules meant to get behind the boilerplate at all.  

Issuers and their advisors should make certain that the “more boilerplate” predictions of some commenters (primarily issuers and advisors) do not become a self-fulfilling prophecy. As the staff has already warned with regard to CD&A disclosure: “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,” — in other words “why?”

Why is it so hard to get to the “why”?  

So it isn’t the “what,” i.e., the purely factual and process parts that’s the problem, but rather the “why” (e.g., the reasons and rationale). But why? Since understanding the reasons for a perceived problem is the necessary first step in overcoming it, it is useful to consider briefly why it may be that issuers and practitioners have difficulty in getting to the “why” in crafting disclosures.

**Boards and their advisors, aren’t used to saying “why.”** That is probably the reason why they predict more boilerplate. The staff’s answer, in sum and substance: “get used to it.”

**What goes on behind closed doors . . .** The lack of detail about decision making 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. Instead they are left to detail the process after the fact.

This has an easy (albeit somewhat self-serving) solution. Not only can the advisors better document a process that they have witnessed, but they can facilitate that process, advise the board along the way, help make certain that directors’ process and deliberation are robust, maybe help the board come to a better result, and better establish a record in broad brush of the most important reasons (pro and con) for the board’s decisions.

But it is also possible that the focus on abstract process, constructs and frameworks as opposed to concrete reasons for decision-making is the result of the fact that the lawyers and advisors are in the room. There is always a danger that lawyers who after all are not equipped to make

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30 Statement of Commissioner Casey. In her comments explaining her decision to vote against the rulemaking, Commissioner Casey stated that her guiding principles included assessing whether new disclosure was likely to “enhance investor understanding [or instead threatened] to significantly expand and / or complicate company disclosures that already are lengthy, dense and oftentimes boilerplate.” With respect to director qualifications and diversity disclosures, discussed infra, Commissioner Casey determined “that commenters’ concerns that this rule may result in boilerplate disclosure are valid.” Id.


32 And remember that telling it like it is means just that. Those crafting the disclosure must take care not to try to improve upon the decision making process after the fact.

33 In this regard, the Adopting Release estimates a total increase in advisors’ fees of approximately $50 million. See Adopting Release at 69.
business judgments, will overly channel and therefore limit board process – the deliberative exchange of ideas that leads to the exercise of sound-even-if-debatable business judgment. Obviously, a proper balance is needed.

**The fuel for the fire concern.** Boards and their advisors fear that being too specific or revealing too much may result in being picked apart for perceived mistakes or omissions by shareholder activists or plaintiffs or SEC enforcement.

If the board has adopted a best practices policy there can’t be much cause for complaint – in the form of investor agitation, litigation or a government enforcement action.\(^{34}\) 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.

The concern here is of course greatest when best practices, or at least good practices backed by good explanations, are eschewed.

**The sausage factory.**\(^ {35} \) The reticence to provide insight into board process may reflect that the sausage-making that goes into many decisions may be messy and the only thing that is important the ultimate outcome.

There is, however, nothing in the rules or in the staff’s comments that require the board to explain every ingredient or every detail about how the sausage was made. Not every reason considered in coming to a good decisions needs to be highlighted or weighted where plenty of good reasons exist and are considered and disclosed. Instead, the general nature of key considerations and whether they generally weighed in favor of the decision or not (but not the relative weights) might be described.

**The whole “holistic” thing.** It is hard to put a “reason” on decisions made by a group as part of a process. This is the basis for commenters’ and Commissioner Casey’s concerns that the new rules seek description of specific reasons where in reality decisions are made on a “holistic” basis.

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\(^{34}\) See n. 23 and accompanying text, infra.

\(^{35}\) As Otto von Bismark is purported to have said, “If you like laws and sausages, never watch them being made.”
instead of issue by issue or, more to the point, person-by-person, as is the case with director qualification disclosures and the issue of diversity.\textsuperscript{36}

Of course, group 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 that are of varying importance to different directors. The rule making suggests that this “diversity” of viewpoints is a normative “good.” The disclosure is not meant to describe every factor pro and con or the views and thought process of each board member. Rather, the record should summarize in a general way the important considerations (pro and con) and not just the conclusion that ultimately resulted in the business judgments that a director is qualified (especially when his contribution is viewed in light of the talents of the board as a whole), that the board’s leadership structure is appropriate (in light of other described checks and balances) and that the risk oversight mechanisms the board has put in place are believed to be adequate (in light of the facts and circumstances).\textsuperscript{37}

**The sanctum sanctorum.** High-level, few-details disclosure may be a reflection of the concern that the new rules are “intrusive” and “encroach” upon the Board’s business judgment.\textsuperscript{38} The sanctum sanctorum of the board room is increasingly open to the public. The “sunlight” is streaming in. Any “father knows best” paternalism has no place in current corporate governance.

This last point, essentially the “intrusiveness” point, subsumes at least some aspects of most of the others. But a reticence to disclose the reasons “why” may only be, at bottom, a concern that the reasons aren’t good or good enough. Or at least that they are not popular with some shareholders. Disclosure of the reasons why is of course less of an obstacle where the board has adopted a policy that approaches best practices. In that case disclosure is an opportunity for some patting on the back. *Instead, explaining the board’s decision making is only difficult in the cases where the board has decided that “good enough is” or that “best practices” aren’t the best choice for their company.* At bottom, that is the hard part.

\textsuperscript{36} See Statement of Commissioner Casey.
\textsuperscript{37} Such risk disclosure will also require that the board have separately determined – although it need not necessarily disclose -- that compensation risks are not likely to have a material adverse effect. The exercise of making such a determination or putting in place risk mitigation measures to permit that conclusion is, as discussed, a “normative good,” which all of the commissioners endorsed.
\textsuperscript{38} Id.
A “How To” Guide for Getting to “Why”

Rather than prompt generic and general boilerplate describing mechanistic procedures or abstract constructs that provide the framework for decision making, boards should view the new disclosure as an opportunity (welcome or not) to reassess the key governance issues targeted by the rules. And, as noted at the outset, because the disclosure assumes that a process has occurred which can then be described in the next proxy statement, boards and their advisors cannot start soon enough. Below, arranged by disclosure topic, are some suggestions as to how boards and their advisors can begin the deliberative process, and develop a robust record that backs up the decisions that they will ultimately be required to disclose and explain.

• “New disclosure of the qualifications of directors and nominees for director, and the reasons why that person should serve as a director”

This should be easy – why did the nominating committee recommend each director? Contrary to the concerns of certain objectors, the Commission does not dictate any considerations or criteria that a board must or even should consider in determining whether or not a director is qualified. So it is left for the board to decide and describe. What does each director bring to the table? His or her experience at other companies, in other industries, at this company? As an executive? A director? A committee member? Does he or she have particular industry expertise? What about more personal or subjective attributes? While you don’t want to pigeon hole anyone, it should be possible to highlight at least a few positive attributes that apply to each director without diminishing the accomplishments of the others.

Contrary to the concerns of some commenters, glorying in the accomplishments of one director should not diminish the qualifications of others. Investors, just like boards, can understand that the board is a sum of, and greater than the sum of, its parts. However, in this regard the suggestion by some that the disclosure be made through a check-the-box matrix is probably counterproductive as it may put as much focus on what characteristics a director may be lacking as it does on their strengths and may also invite the sort of person-by-person and trait-by-trait comparison that Commissioner Casey and some commenters found problematic.

While it may take some thought, and any disclosure should note that the list of qualifications is not exhaustive, without disclosure of at least some of the most important of the board’s actual reasons for determining why a director is qualified, investors will have less ability to understand

\(^{39}\) Nonetheless, many commenters’ and Commissioner Casey’s major objection to the new rule making was with respect to disclosure of individual board members’ qualifications. See Statement of Commissioner Casey and n. and accompanying text supra.
why the decision is sound.

The concern that the disclosure of director qualifications may be “intrusive” will exist only where the board’s nomination process or a directors’ qualifications are deficient. Perhaps the concern is that it may be difficult to characterize certain incumbent board members’ qualifications in a way that is satisfactory to investors? Boards should start assessing this now. They should begin putting together the record of why each director is qualified that includes and, where the board is staggered, even supplements what the nominating committee determined at the time of the director’s original nomination since the operative date for the disclosure of qualifications is when the proxy is filed. The board should also consider changes now if there is any concern that a particular director is not qualified or less qualified than is desirable. It will be interesting to see if there are any significant changes in the composition of boards as a result of this rule making.

- **Additional disclosure of any directorships held by each director and nominee at any time during the past five years.**

If any of your directors has served at any company that was involved in the recent financial credit crisis, had a major accounting restatement or has been accused of fraud, investors and the SEC want to know.\(^\text{40}\) Boards should begin gathering this information now and determine the pros and cons of keeping any directors who have had the misfortune of serving (probably ably) on the board of a troubled company so that they can explain and defend their decisions.

- **Additional disclosure of other legal actions involving a company’s executive officers, directors, and nominees in the prior ten years.**

Ditto and then some. Of course, every public company is likely to have been the target of often-frivolous shareholder litigation.\(^\text{41}\) Where this is the case, disclose the result – often dismissal or a nuisance settlement with no finding of wrongdoing.

- **New disclosure about a company’s board leadership structure.**

Obviously, corporate governance watchdogs want companies to separate the functions of board Chair and company CEO. If your company has separated these positions, pat yourself on the back and explain why, feeling free to borrow from the litany of reasons provided by the

\(^{\text{40}}\) See, e.g., Gretchen Morgenson, “What Iceberg? Just Glide to the Next Boardroom,” The New York Times, Dec. 26, 2009 (“You might think that board members overseeing businesses that cratered in the credit crisis would be disqualified from serving as directors at other public companies. You would be wrong.”)

\(^{\text{41}}\) Statistics from NERA and Cornerstone.
governance community about why this structure is best.

If your company has not separated the functions, there must be good reasons that the board should re-examine now, re-affirm now, and consider changing now. If there is a decision to keep the CEO as the Chairperson, the board should strongly consider appointing a lead independent director (if it hasn’t already) and explaining how this function (as well as executive sessions of independent directors, etc.) will act as a check against any perception that management dominates the board and corporate policy. Consider citing examples, if they are not overly sensitive, where the board’s actions deviated from management’s interests, e.g., with respect to compensation. The board with a combined CEO/Chairman function should also consider citing studies showing that there is no correlation between separation of functions and corporate performance, hopefully citing their company’s own superior performance as the best example.

A company that does not separate the functions of the CEO and Chairman cannot rely on the “it’s always been this way” “it’s always worked” “if it ain’t broke don’t fix it” approach, or at least does so at its peril. A board with a CEO/Chairman that cannot support that decision with good reasons or with examples demonstrating that the board is independent and acts independently and that corporate performance is (more than) satisfactory, is inviting the scrutiny of activist groups and the SEC. Since such companies may have a hard time justifying a decision on this point, they, especially, should begin thinking about the justifications for continuing to combine the CEO and Chairman functions now.

- **New disclosure regarding the consideration of diversity.**

Diversity is in the eye of the beholder. Remember, too, you don’t have to have a diversity policy. You don’t have to say anything about diversity unless you have a diversity policy. If you do have a diversity policy you have to explain it and explain how it is implemented. If you don’t have a diversity policy, you may have to explain yourself to the governance world.

- **Disclosure of the vote results from a meeting of shareholders on Form 8-K generally within four business days of the meeting.**

No more waiting until and/or hiding results in quarterly filings.

- **New disclosure about the board’s role in the oversight of risk.**

The Adopting Release suggests that “[d]isclosure about the board’s approach to risk oversight
might address questions such as whether the persons who oversee risk management report directly to the board as whole, to a committee, such as the audit committee, or to one of the other standing committees of the board; and whether and how the board, or board committee, monitors risk. The Release also posits the possibility of a separate risk committee and suggests that some description of the process and individuals responsible for providing information to the board might be useful to investors. Given the source, these suggestions are probably a good place to start. Boards might also consider continuing education on emerging risk management.

- To the extent that risks arising from the company’s compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company’s compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company’s risk and management of risk.

The key here is to get to a place where the board can check the box “not applicable.” In order to achieve this, the board must develop an understanding of the compensation system for all employees and assess (better with the help of independent advisors) whether and how any performance incentives may unintentionally incentivize misconduct. The board must then develop checks and balances (again, better with the help of independent advisors) meant to minimize any risks to a point that experts can advise that a material adverse effect resulting from perversion of compensation incentives is unlikely to occur. All of this is great process. Risk identification and minimization will almost certainly increase value.

The Adopting Release provides illustrative examples of circumstances in which compensation policies “may have the potential to raise material risks to companies,” and also “examples of the types of issues that would be appropriate for a company to address,” while stressing that “the situations that would require disclosure will vary depending on the particular company and its compensation program.” The SEC stated that “situations that potentially could trigger discussion include, among others, compensation policies and practices:

42 Adopting Release at 40.

43 The Adopting Release also suggests that “disclosure about the board’s involvement in the oversight of the risk management process should provide important information to investors about 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. This disclosure requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals.” Id. at 44.


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

“At a business unit with compensation structured significantly differently than other units within the company;”

“At a business unit that is significantly more profitable than others within the company;”

“At a business unit where the compensation expense is a significant percentage of the unit’s revenues;” and

“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.”

While “[t]his is a non-exclusive list of situations where [the SEC believes] compensation programs may have the potential to raise material risks to the company,” it is obviously a starting list of questions every board of directors should ask.

Similarly, even if boards and their advisors determine, either prima facie or as a result of changes to compensation policy, that their compensation practices do not present a material risk, they are well advised when making such determinations to address the issues targeted by the SEC. In this regard, the Adopting Release provides “examples of the issues that companies may need to address regarding their compensation policies or practices” if material risks are deemed to be present. The SEC suggests analysis of the following issues:

“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;”

“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 claw backs 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 made to its compensation policies and practices as a result of changes in its risk profile;” and
• “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 its employees.”

• **New disclosure about the fees paid to compensation consultants and their affiliates under certain circumstances.**

If you want more than surveys or general industry information, hire someone who doesn’t do other work for the company and someone other than someone recommended by the CEO.

**Good Governance and Good Governance Disclosure is Good For You**

While it is undeniably true that the SEC can’t regulate governance, and as equally undeniably true that the SEC wouldn’t mind if the new rules focused on better disclosure have the extra “benefit” of encouraging better governance, the new rules clearly presume there will be an examination of governance practices and that this may in some instances result in change towards best practice. Not such a bad thing. If, on examination, the board, management and/or their advisors are concerned that the “why” isn’t good enough, then that conclusion should prompt the board to re-examine its decisions. Perhaps there are in fact other legitimate reasons for the decision that can be better articulated. If not, changes or improvements may well be in order. If the status quo, on reflection, presents unacceptable risks or is not “best practices,” shouldn’t the board assess that conclusion and consider what changes might be made or what counterbalancing mechanisms are or can be put into place?

Going forward, boards and their advisors should make sure that the quality of their deliberative process is as good as possible and that this is apparent in the company’s disclosures. Where the deliberative process is in fact rich and considered, as is usually the case, the board can get credit not only for its good decisions but also its good decision making by providing fuller disclosure. And if board process could be better, the rules offer an opportunity for beneficial self-examination.

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48 *Id.* at 15-16. Again, the Adopting Release warns that the examples are illustrative and not exclusive: “We believe using illustrative examples helps to identify the types of disclosure that may be applicable. However, companies must assess the information that is identified by the example in light of the company’s particular situation. Thus, for example, we would not expect to see generic or boilerplate disclosure that the incentives are designed to have a positive effect, or that compensation levels may not be sufficient to attract or retain employees with appropriate skills in order to enable the company to maintain or expand operations.” *Id.* at 16.
and improvement. The hope is that these new (and any) disclosure requirements will not only prompt better decision making, but also help to prevent bad decisions from being made. 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 little concern about liability (as opposed to litigation) 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. Best practices are aspirational goals that aren’t required and aren’t required to avoid liability. But best practices will help to limit liability and even litigation and activist challenges.

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.

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

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49 Although, unfortunately, good decisions and good practices and even best practices will not prevent litigation. See n. 50, infra. Economists at NERA determined in 2005 that public companies had a 2 percent annual likelihood of being sued by shareholders although the high dismissal rate of such cases results in the probability of a company facing a suit that survives a motion to dismiss at 1.2%. Elaine Buckberg, Todd Foster and Ronald I Miller, “Recent Trends in Shareholder Class Actions: Are Enron and WorldCom the New Standard?” NERA, July 2005, available at http://www.nera.com/image/Recent_Trends_07.2005.pdf. Conversely, formulistic “best practices” that are not followed or become a “check the box” substitute for oversight or business judgment may result in both litigation and potential liability, as occurred with Enron and WorldCom, for example.

50 See In re Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006) (although “many aspects of the defendants’ conduct...fell significantly short of the best practices of ideal corporate governance,” “Delaware law does not...hold fiduciaries liable for a failure to comply with the aspirational ideals of best practice.” In re the Dow Chemical Corp. Derivative Litig., (Del. Ch. 2010) (same).” In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009) (noting “the well settled policy of Delaware law [not] to perform a hindsight evaluation of the reasonableness or prudence of directors’ business decisions.” ) As the Chancery Court stated in dismissing the Disney case (after trial and a decade of litigation), “failure to comply with the aspirational ideal of best practices” does not state a cause of action. As the Chancellor explained: “Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decisions-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike. That is why, under our corporate law, corporate decision-makers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and abilities dictate, free of post hoc penalties from a reviewing court using perfect hindsight. Corporate decisions are made, risks are taken, the results become apparent, capital flows accordingly, and shareholder value is increased.” Thus, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational”, provides no ground for director liability, so long as the court determines that the process employed was [undertaken] in a good faith effort to advance corporate interests.” See In re Walt Disney Co. Deriv. Litig., 907 A.2d 893, 750 (Del. Ch. 2005), aff’d, 906 A.2d 27 (Del. 2006). For this reason, Commissioner Casey’s concern that “the disclosure obligations [might] intrude on management’s conduct of the company’s ordinary business operations or on the board’s exercise of its business judgment” should not be a major concern. See Statement of Commissioner Casey . The board can, should and will still exercise its business judgment and in a thoughtful manner and at worst may be encouraged to be just a little bit more so given the need to disclose something of its process.

51 See In re Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006) (noting that considered and well documented board deliberations will help avoid protracted litigation).
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.

Instead, by going through the process of considered deliberation concerning the targeted governance matters and then disclosing the reasons for their decisions and their policies, 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 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 Adopting Release admonishes, “we would not expect to see generic or

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52 Indeed, the fact that more disclosure will lead to more informed and therefore maybe to different investment decisions is the point of the rule. The SEC lists as a major benefit of the rulemaking the facts that “[i]nvestors would be able to make more informed voting decisions in electing directors. Investors would also be able to adjust their holdings, allocating more capital to companies in which they believe board members are most likely to be able to effectively fulfill their duties to shareholders. In particular, in cases that do not meet investors’ expectations, investors may respond by attempting to exert more influence on management or the board than would occur otherwise, thereby enhancing shareholder value.” Adopting Release at 80.

53 See n. 23, and accompanying text.

54 Id.

55 Commissioner Casey acknowledged that disclosure of compensation risk and the provision of information concerning potential conflicts of interest of compensation consultants “can be relevant and important to investors” and was a “normative good” and commended the fact that issuers would only be required to “discuss their compensation policies or practices, as they relate to risk management and risk-taking the policy or practice creates risks that are reasonably likely to have a material adverse effect on the company.” One would presume that if a material risk arising from compensation incentives is identified, controls will be put in place to mitigate the risk that will be sufficient to avoid having to disclose a conclusion that the risk is material.

56 See n. 23, supra, and accompanying text.
boilerplate disclosure that [policies] are designed to have a positive effect, or . . . may not be sufficient to [achieve some general corporate purpose].” Instead, 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,” — in other words “why?”.

Appendix A

The amendments that we are adopting will require:

- To the extent that risks arising from a company’s compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company, discussion of the company’s compensation policies or practices as they relate to risk management and risk-taking incentives that can affect the company’s risk and management of that risk;

- New disclosure of the qualifications of directors and nominees for director, and the reasons why that person should serve as a director of the company at the time at which the relevant filing is made with the Commission; the same information would be required in the proxy materials prepared with respect to nominees for director nominated by others;

- Additional disclosure of any directorships held by each director and nominee at any time during the past five years at any public company or registered investment company;

- New disclosure regarding the consideration of diversity in the process by which candidates for director are considered for nomination by a company’s nominating committee;

- Additional disclosure of other legal actions involving a company’s executive officers, directors, and nominees for director, and lengthening the time during which such disclosure is required from five to ten years;

- New disclosure about a company’s board leadership structure and the board’s role in the oversight of risk;

- New disclosure about the fees paid to compensation consultants and their affiliates under certain circumstances; and

- Disclosure of the vote results from a meeting of shareholders on Form 8-K generally within four business days of the meeting, and new disclosure about leadership structure and the board’s role in the oversight of risk.

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57 Adopting Release at 16.