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Get Ready! What Public Retail Companies Should Do Now to Prepare for the 2010 and 2011 Proxy Seasons

Last year, public retailers witnessed a high-water mark for shareholder proposals, proxy campaigns, and withhold recommendations at their annual shareholder meetings. Incumbent boards faced off in numerous clashes with activists, culminating in the bruising (and painfully expensive) proxy battle between mega-retailer Target and investor Bill Ackman's Pershing Square Capital. If a successful retailer of Target's caliber can come under prolonged attack, no publicly listed retailer should assume it is exempt. More fireworks are expected in 2010, and proxy advisor RiskMetrics Group predicts that this year will witness a record number of shareholder proposals.

As investors have increasingly asserted themselves, regulators and legislators have also shown greater willingness to intervene in company governance. Simply put, for many public retailers upcoming proxy seasons could be the most challenging in years. While shareholder meetings — and the proxy campaigns that precede them — will continue to be a flash-point in 2010 and beyond, companies can take steps now to help promote better shareholder relations, avoid corporate governance conflict, and win the day should a conflict arise.

Preparing for the next couple of proxy seasons begins with understanding how the playing field has changed — and what further changes still lie ahead. Accelerated by recent events, boards of publicly traded retailers can expect their nominees and proposals to face higher hurdles than ever before. Activists continue, by contrast, to gain relative advantage. Here's how:

- The Securities and Exchange Commission ("SEC") is committed to opening up the company's proxy to shareholder nominees. "Proxy access" won't happen in 2010, but it is likely coming in 2011. When it does, shareholder nominations of directors will increase. How much they will increase is yet to be determined.

- 2010's proxy statements will likely have new parameters that "set the stage" for the following year's proxy access:
  - New disclosures will force companies to justify their nominees and governance structures as never before.
  - "Broker non-votes" for directors are now prohibited, which will result in lower "for" votes for directors nominated by the board and make achieving quorums more difficult.
  - Executive compensation and risk oversight practices will be in the bull's eye — even more than in the past.

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- Congress could wade in at any moment — changing the game by legislative fiat. Pending proposals could impose a one-size-fits-all federal governance structure that may be inappropriate for many companies. Among other initiatives:
    - o Shareholders may get an annual “say on pay” vote on executive compensation.
    - o Public company governance may become federalized — with mandatory annual elections of all directors and majority voting standards. Non-independent board chairs could be abolished.
    - o Further restrictions on executive pay may become law — and they may well encompass more than the financial industry.

A potential bright spot is the admission by regulators that something needs to be done in two neglected corners of the proxy world. The SEC has hinted at reining in unregulated proxy advisors and also addressing the archaic mechanics of counting votes, which have not kept pace with 21st century share ownership practices. Still, with no proposals yet on the table, public retailers should not expect much help in dealing with proxy season challenges, at least this year.

We discuss these and other regulatory issues at length in the attached Appendix A. Generally, however, the following recommendations should help public companies more smoothly navigate the stormy waters ahead.

First, company boards should acknowledge the evolving relationship between management and shareholders. Accepting and acting on this trend means taking steps now to encourage positive relations with significant institutional shareholders as a bulwark against criticism from activists. The analysts at your institutional shareholders are well known to you, but they can be of little help if a governance dispute arises. Reach out to the individuals who vote your proxies at your institutional shareholders to understand their perspective. Open up the communications process to allow year-round interaction, not simply during proxy season. Establish a cordial relationship before you receive a shareholder proposal or withhold recommendation. Take the time to understand what corporate governance matters your institutional shareholders care about. Promote transparency. In these ways, companies can demonstrate board responsiveness and accountability before it is brought into question by activists.

Second, management must reconsider its approach to annual proxy disclosures for several important reasons. Shareholders continue to seek out clear explanations of the company’s management and compensation philosophies. Inadequate pay practices or opaque disclosure is a frequent cause for proxy advisors recommending a “withhold” vote against directors. New compensation-related disclosure requirements have just been finalized by the SEC, which may catch some off guard, requiring issuers to scramble to obtain the necessary information to comply.

In December 2009, the SEC adopted a number of changes to its proxy disclosure rules that will be effective for most issuers in the 2010 proxy season. (See details in Appendix A along with our specific recommendations on how to address these changes). The new rules require enhanced disclosure in the following areas:

- How a company’s compensation policies and practices for all employees affect the company’s risk and management of risk, if the risks arising from such policies and practices are reasonably likely to have a material adverse effect on the company;

- The company’s leadership structure (such as whether it separates or combines the CEO and chairman of the board positions) and the reason(s) the company has chosen its particular leadership format;

- The board of directors’ role in risk oversight;

- The specific qualifications and attributes of directors and nominees for director that qualify them to serve on the board, any directorships held by them in the past five years and increased disclosure of involvement by them in legal proceedings during the past 10 years;

- How diversity is considered in the selection of board nominees;

- Fees paid to compensation consultants if they played a role in determining or recommending the amount or form of executive or director compensation and provided more than $120,000 of additional services to the company; and

- Stock award and option award disclosure, imposing a new requirement that grants to executives and directors be reported at grant date fair value.

As a result, we recommend that issuers immediately start taking the following steps to ensure that timely compliance can be achieved in their 2010 proxies:

- In response to the new disclosure rules, which are an outgrowth of the recent financial crisis, companies should critically re-evaluate and clarify their approach to and oversight of enterprise risks — not simply risks related to internal controls over financial reporting.
- Evaluate and disclose (when required) whether your compensation policies for all employees, not only your named executive officers, encourage excessive risk taking. Consider revised policies that may lessen this risk.
- Expect to have candid discussions about director qualifications, board composition and the company's choices in governance structures. Be prepared to expand the proxy discussion of each director's qualifications and how that director is essential to the proper functioning of the board. The proxy is the best opportunity for management and the board to make their case to the shareholders before a governance dispute arises. Take advantage of it.

All of these matters will be put to record in the proxy statement, but the process begins well in advance with serious thinking about these topics. Leading public companies address all of them, but they may not have communicated their philosophies adequately or formalized their thinking or processes. Where a retailer's corporate affairs have been well-managed, management should view the proxy statement as a tool to tout the strengths of corporate leadership, accentuating positives that will help the company's story be heard in the face of outside criticism. We encourage retail companies to view their proxy statement as another key opportunity for improving communications with long-term shareholders.

Finally, public retailers need to monitor further SEC and legislative proposals and, of course, keep an eye on developing issues with proxy advisors. We know that regulators have a number of rulemaking proposals in the hopper. More momentous statutory changes are also pending before the U.S. Congress. These range from rules for expanded disclosure to "say on pay" and other "shareholder enfranchising" measures to punitive sanctions against "excessive" compensation. In the current political environment, it is very difficult to judge the likelihood that even the more extreme measures could become law. (A complete run-down of these proposals begins on page 13 of Appendix A). Finally, RiskMetrics Group, Glass-Lewis and other proxy advisors annually tweak their voting guidelines, many of which could result in shareholders voting to remove directors who don't observe these preferred policies. Until regulators come to grips with the outsized influence of proxy advisors, a public retailer ignores their admonitions at its own risk.

The rules of the game have been shifting for some time, and the trend is about to accelerate. Publicly traded retailers that heed recent developments, prepare in advance, and execute well-designed plans for the emerging investment environment will find themselves far better positioned than those who take the status quo for granted.

See our checklist in Appendix B for a quick list of important action items.

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It is critical that public companies familiarize themselves with the sweeping changes to proxy disclosures and the proxy process that have been proposed both by the SEC and in Congress. Some of these have become effective, and many others may soon be. In addition, an array of far-reaching legislative reforms have been introduced or circulated as discussion drafts. The remainder of this memo discusses these measures in detail.

2010 Proxy Season Considerations

Disclosure Changes

On Dec. 16, 2009, the SEC adopted rule changes for proxy disclosure that significantly change the required proxy statement disclosures of retail issuers. These rules will become effective on Feb. 28, 2010 and will apply to most issuers in the 2010 proxy season.[1]

Retail issuers should be familiarizing themselves now with the new rules and preparing to implement disclosure changes in their upcoming proxies. Among other things, the new rules: require additional disclosure regarding the qualifications of directors and board leadership structure; require disclosure about compensation consultants' fees and services when a consulting firm is engaged to perform services for a company beyond providing executive compensation advice to the board or a compensation committee (to the extent that payment for such services exceeded $120,000); require additional disclosure when a company's compensation policies encourage risk taking; and change the method by which stock and option awards are reported to require compensation to be reported at the aggregate fair value of an award on the date of grant.

Expanded Director, Director Nominee and Executive Officer Disclosure

Director and Nominee Disclosure

Item 401(e) of Regulation S-K was amended to require enhanced disclosure about director and nominee qualifications. The new requirements apply to the proxy statement and annual report, as well as any registration statement which discusses such individuals. The additional disclosures include:

- The specific experience, qualifications, attributes, or skills that qualify each individual to serve as a director and as a member of any board committee, in light of the company's business; and
- All directorships held at public companies during the past five years (previously only current directorships required disclosure).

Legal Proceedings

Item 401(f) of Regulation S-K has been amended to expand the period and categories of required legal proceedings disclosure for directors, director nominees and executive officers. Legal proceedings from the prior ten years must now be disclosed (previously, only five years of proceedings were required). New categories of proceedings have also been added, to the extent that such proceedings are not subsequently reversed, suspended or vacated, which include the following:

- Proceedings involving any law or regulation prohibiting mail or wire fraud;
- Proceedings involving federal or state securities, commodities, banking or insurance laws and regulations, and any settlement of such actions; and
- Disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

1. The SEC issued an interpretive release on Dec. 22, 2009, which provided clarification regarding the transition to the new rules. For all issuers whose fiscal years end on or after Dec. 20, 2009, Form 10-Ks, proxy statements and registration statements must comply with the new rules if filed on or after Feb. 28, 2010. A proxy statement that contains information incorporated into a Form 10-K must comply with the new rules if the definitive proxy statement is filed after Feb. 28, 2010. If the issuer is required to file a preliminary proxy statement and the issuer expects to file a definitive proxy statement after the effective date, the preliminary proxy statement must also comply with the new rules even if filed before Feb. 28, 2010. An issuer whose fiscal year ends before Dec. 20, 2009 does not have to comply with the new rules until it files its 2010 Form 10-K. Proxy and registration statements for such reporting issuers filed before then are not subject to the new rules, even if filed after Feb. 28, 2010. Voluntary compliance is permitted except that if an issuer elects to adopt the rule change in the reporting of equity award values in the summary compensation table, it must also comply with all of the other Regulation S-K amendments.

As a result, public companies should consider taking the following actions now:

- Revising their D&O questionnaires to reflect the expanded disclosure requirements; and

- Reviewing the expanded disclosure requirements when evaluating persons for nomination or re-nomination to the board and board committee positions.

Board Leadership Structure and Risk Oversight Role

A new Item 407(h) of Regulation S-K requires the inclusion in the proxy statement of a discussion regarding a company's leadership structure and why the company believes its leadership structure is best for the company, including:

- Whether and why the company has chosen to combine or separate the chief executive officer and board chair positions; and

- Whether and why the company has a lead independent director and the lead independent director's role in company leadership.

As a result, public companies should consider taking the following actions now:

- Asking governance committees to begin discussing what new disclosures would be made in the 2010 proxy statement and whether any changes may be appropriate;

- Updating and expanding their diligence files on each director's (and nominee's) qualifications and experience. Companies should determine how this information should be gathered, *i.e.*, expanded director and officer questionnaires, separate questionnaires, etc.;

- Nominating committees should also start reviewing directors' qualifications to serve on the board and on their committees, and consider whether it may be appropriate to make reassignments or provide additional training in areas of focus for committee members; and

- Giving consideration to adopting the structure implicitly recommended by the new rules, *i.e.*, separating the positions of chief executive officer and chairman of the board.

New Item 407(h) of Regulation S-K also requires that the proxy statement include information about the board's role in risk management, and the effect (if any) that this has on the way the company has organized its leadership structure. The SEC would want specific disclosure about how a company perceives the role of its board of directors and the relationship between the board and senior management in managing material risks that the company might face.

Compensation Programs and Risk

A new Item 402(s) of Regulation S-K requires that reporting companies (other than smaller reporting companies) discuss their compensation policies and practices for all employees to the extent such compensation practices or policies are "reasonably likely to have a material adverse effect" on the company. These changes were brought about based on concerns raised by investors and other regulators that compensation structures were responsible for fueling the financial crisis by encouraging excessive risk-taking to achieve short-term goals without sufficient regard for long-term company well being.

Each company must evaluate its compensation policies and practices and make a determination as to whether any additional disclosures would need to be made as a result of this new requirement. If a company determines that such disclosure would be required, it need not be contained in the Compensation Discussion and Analysis section of the proxy statement, which is typically reserved for a discussion of named executive officer compensation.

The situations that would require such disclosure will be company specific. However, new Item 402(s) of Regulation S-K includes a list of non-exclusive examples of situations that could potentially trigger a disclosure requirement, such as compensation policies and practices:

- At a business unit whose operations entail a significant portion of the company's overall risk;

- At a business unit that has compensation arrangements structured significantly different than at other units;

- At a business unit that is significantly more profitable than other units;

- At a business unit whose compensation expense constitutes a significant percentage of the unit's revenues; and

- That vary significantly from the company's overall risk and reward structure, 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.

The SEC also provides in Item 402(s) a non-exclusive list of issues that may need to be disclosed when a company determines that the risks arising from its compensation policies and practices are likely to result in a material adverse effect on the company. Such issues would include:

- The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by such policies and practices;

- 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 (for example, through clawback policies or company imposed 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 creating incentives for its employees.

This is the first time companies have been asked to evaluate their compensation policies and practices beyond their executive officers and directors for proxy statement purposes. As a result, public companies should consider taking the following actions now:

- Evaluating with the board of directors, compensation committee or audit committee the general design philosophy of a company's compensation policies and practices, elements of compensation, how performance goals are structured, how adjustments are made or policies are changed based on changes in risk profiles and how compensation policies are monitored with respect to risk;

- Focusing on whether the company's compensation policies and practices for employees generally are reasonably likely to have a material adverse effect on the company;

- Evaluating compensation risks before setting future compensation; and

- Evaluating the compensation policies and amounts of the company's nearest competitors and adjusting compensation based on what competitors are doing.

Board Diversity Policy

Item 407(c) of Regulation S-K will now require disclosure about whether a nominating committee considers diversity in identifying director nominees. In addition, if the nominating committee or the board has a policy regarding the consideration of diversity in identifying director nominees, disclosure will be required about how this policy is implemented, as well as how the nominating committee or the board assesses the effectiveness of its policy.

The term "diversity" is not defined in the new rules and the SEC has indicated that the term may be interpreted broadly. Possible diverse criteria include: differences in viewpoint, professional experience and skills, in addition to race, gender and national origin.

Enhanced Compensation Consultant Disclosure

The new rules may also require more detailed proxy disclosure related to compensation consultants and potential conflicts of interest. Item 407 of Regulation S-K was amended to require enhanced disclosure regarding compensation consultants and potential conflicts of interest when:

- The consultant was engaged to provide advice or recommendations on executive and director compensation (other than with respect to broad-based plans or based on non-customized information, as explained below);

- The consultant (or its affiliates) also provided consulting services to the company with respect to non-executive compensation; and

- The aggregate fees paid for the non-executive compensation consulting services exceeded $120,000 in the last fiscal year. Note that this dollar threshold is the same one used for assessing related party transactions in Item 404 of Regulation S-K, which also relates to potential conflicts of interest.

If each of the above three conditions are satisfied, the company must disclose:

- The aggregate fees paid for determining or recommending the amount or form of executive and director compensation; and

- The aggregate fees paid for non-executive compensation consulting services provided by the compensation consultant or its affiliates.

Additionally, if the compensation consultant was engaged by the company's compensation committee (or persons performing equivalent functions), the company must disclose whether the decision to engage the compensation consultant (or its affiliates) to provide non-executive compensation consulting services was made or recommended by management and whether the compensation committee or the board approved such engagement.

The SEC also adopted two narrow exclusions from the new compensation consultant disclosure requirements. First, no additional disclosure will be required if the board, compensation committee, or other persons performing equivalent functions and management engage separate consultants to advise on executive or director compensation so long as the consultant advising the board, compensation committee, or other persons performing equivalent functions does not provide additional non-executive compensation consulting services to the company.

Second, the additional disclosure will not be required if: (i) the compensation consultant is engaged solely to recommend the amount or form of executive or director compensation in connection with broad-based plans that do not discriminate in favor of executive officers or directors and that are generally available to all salaried employees or (ii) the compensation consultant's services are limited to providing information that is not customized for the company (such as surveys), or are customized based on parameters that are not developed by the compensation consultant, provided that the compensation consultant gives no advice and makes no recommendations in connection with providing such information.

The enhanced compensation consultant disclosures are intended to provide investors with more complete information so that investors may better assess the objectivity and financial interests of a compensation consultant. As a result, public companies should consider taking the following actions now:

- Begin evaluating the scope of the engagement of a compensation consultant, if any, including the fee arrangement, for purposes of:
    - o Determining whether the current fee arrangements may compromise the objectivity of the compensation consultants' recommendations related to director or executive compensation because of fees earned from the additional services provided; and
    - o Evaluating potential enhanced disclosures that may be required under the new rules; and

- Using independent consulting firms when seeking executive compensation advice to avoid the appearance of impropriety.

Stock and Option Award Tabular Disclosure

Changes have also been made to required disclosures of stock and option awards under Item 402 of Regulation S-K. The aggregate grant-date fair value of awards computed in accordance with FASB ASC Topic 718 (previously SFAS 123R) must be reported in the Summary Compensation Table instead of the dollar amount recognized for financial statement reporting purposes.

The SEC is also requiring that companies recalculate prior fiscal year compensation amounts in the Summary Compensation Table because of the change in the manner in which stock and option awards are calculated. The grant date fair value of such performance awards should be based on the probable outcome of the performance conditions, measured as of the grant date. Companies will also be required to include a footnote to the Summary Compensation Table and Director Compensation Table disclosing the maximum value payable under each performance award assuming the highest level of performance.

To make an accurate year-to-year comparison of the Summary Compensation Table amounts possible, companies with fiscal years ending on or after Dec. 20, 2009, are required to recalculate the grant date fair value of stock awards and option awards and update the total compensation column for each named executive officer in the three most recently completed fiscal years. If the change in total compensation for a prior year would change who the previously reported named executive officers were, companies will not be required to change them retroactively, with one exception. Where a named executive officer in the most recently completed fiscal year (2009) was not included as a named executive officer in the preceding fiscal year (2008) but was included in the fiscal year prior to that (2007), the company must then report the named executive officer's compensation for each of the three most recently completed fiscal years.

Shareholder Voting Results on Form 8-K

A new Form 8-K Item 5.07 will require that companies report the voting results from a shareholder meeting within four business days after the end of the meeting in a current report on Form 8-K, instead of providing this disclosure in a Form 10-Q or Form 10-K covering the period in which the meeting was held (as previously required). If definitive voting results are unavailable within four business days, companies must disclose preliminary voting results in the 8-K and file an amendment thereto once the final voting results become available.

Broker Non-Votes

On July 1, 2009, the SEC approved an amendment to NYSE Rule 452 prohibiting brokers from voting shares held in street name in uncontested director elections unless the beneficial owner has provided voting instructions. Before this amendment, brokers frequently voted all their uninstructed shares for the board nominees in uncontested director elections. Such votes were colloquially called "broker non-votes" and were allowed since uncontested director elections were considered uncontroversial, similar to the ratification of auditors. Because essentially all brokers are members of the NYSE and, therefore, bound by this rule change, this amendment affects all public companies.

The amendment to Rule 452 raises a quorum issue. Uninstructed shares held by brokers cannot be counted for quorum purposes unless there is a proposal that those shares can vote on. In the past, uncontested director elections played this role. With that fallback gone, companies now must be sure that there is another item that uninstructed shares can vote on at the meeting or those shares will be lost for quorum purposes. The simplest solution is to be sure to include a proposal to ratify the company's auditors since brokers can vote uninstructed shares for auditor ratification. For companies that have not voted on the ratification of auditors in the past, it should be a non-controversial item. Many public companies include the matter at their annual meetings, and there is no meaningful downside to doing so.

The more significant issue raised by the change to Rule 452 concerns the actual vote in uncontested director elections. According to the RiskMetrics Postseason Report released in October 2009, broker non-votes were, on average, 19 percent of all shareholder votes in 2009. Removing broker non-votes will, in many instances, reduce the total vote for uncontested directors by a non-trivial amount. As a result, withhold vote recommendations and campaigns will be more effective, and activist and institutional investors will have proportionally more influence.

The impact of the change is even greater if directors are subject to majority and not plurality voting. A low vote in an uncontested plurality election can be a public relations issue for the company and an embarrassment to the director. In a majority voting regime, the lack of broker non-votes could help push the vote below the 50 percent level required for election or trigger a duty to resign, depending on the type of majority voting in place.

Companies can take a number of proactive steps to evaluate and mitigate the risk posed by the amendment to Rule 452. As a first step, it is important to consider shareholder mix, particularly how shares are distributed between institutional and retail ownership. Also important is an evaluation of participation and voting patterns over the last two to three years. What is the retail response rate? Are shares held by one of the brokers that stopped voting unrestricted shares in previous proxy seasons and do such brokers achieve a higher response rate from their customers? Another factor to consider is the use of notice and access for proxy delivery rather than full delivery of proxy materials. On average, notice and access negatively impact the response rate from shareholders and therefore act as a further drag on retail voting. Considering these factors together should help indicate whether the reduction in retail voting is likely to materially impact director approval.

Where there is a meaningful risk, steps should be taken to increase retail voter response. As indicated above, choosing full delivery of proxy materials over notice and access will likely increase retail response. Conspicuous language explaining the rule change and the increased importance of responding can be added to the proxy materials. Active proxy solicitation can also be undertaken. From another angle, companies facing significant reductions in broker non-votes should consider taking additional steps to reduce the chance of an organized campaign against one or more directors or a recommendation to withhold from a proxy service.

Shareholder Proposals on CEO Succession and Company Risks

At the end of October, the SEC released a legal bulletin announcing a new approach to company requests to exclude certain types of shareholder proposals from the company proxy. Exchange Act Rule 14a-8(i)(7) allows companies to exclude shareholder proposals that concern the ordinary business operations of the company. In the past the SEC has interpreted this rule to allow the exclusion of both CEO succession proposals and certain proposals concerning the risks to the company of large scale environmental, financial or health issues, such as climate change. Now CEO succession proposals will be allowed — if they overcome other limitations, such as micromanagement of the company — on the theory that CEO succession is a significant policy issue concerning corporate governance, not an ordinary course workforce management issue. For environmental, financial and health risk proposals, the SEC will now consider requests to exclude such proposals by evaluating whether the covered risk concerns the day-to-day operations of the company or whether it concerns a more significant policy issue with a connection to the company of sufficient significance to make it appropriate for a shareholder vote. Before the October legal bulletin, if the shareholder proposal could be described as attempting to force the company to evaluate risks internally, then it was excludable. Moving from a process focused evaluation to a broader relevancy evaluation should result in more SEC denials of no action requests to exclude these types of proposals. The SEC also took the opportunity to note that shareholder proposals concerning the board's role as risk manager would likely meet the significant policy test.

Activist Shareholders and Proxy Advisors

2010 is expected to be another active proxy season for activist shareholders and for the proxy advisor firms RiskMetrics and Glass Lewis.

One of the most common shareholder proposals in recent years has been for the institution of majority rather than plurality voting for directors. Adoption of majority voting means a director running in an uncontested election must receive at least 50 percent of the shareholder vote to be elected, rather than the single vote sufficient in an uncontested plurality election. There is no reason to believe that this trend will stop in 2010, particularly since the broker voting rule change discussed above will make it harder to reach the 50 percent threshold.

Other issues that were the frequent subject of shareholder proposals in 2009, and will likely continue to be so in 2010, were say on pay, special meeting rights for shareholders (either allowing shareholders to call special meetings or lowering the ownership threshold to be allowed to call one), removing supermajority voting requirements, requiring that board chairmen be independent, and board declassification.

The proxy advisory firms generally exercise their power by recommending "against" or "withhold" votes for director nominees. Institutional investors generally follow these recommendations, so the advisors are particularly important to companies with high levels of institutional ownership. The influence of the proxy advisors is also increasing with the reduction in retail voting due to notice and access proxy delivery and the end of undirected broker voting in uncontested director elections. Companies with majority voting for directors are particularly vulnerable to a withhold recommendation.

RiskMetrics has released 2010 proxy season updates to its corporate governance guidelines, highlighting areas RiskMetrics is likely to focus on in their voting recommendations this year, in addition to past areas of focus. For 2010 RiskMetrics has stiffened its policy against non-shareholder approved poison pills. In the past it has recommended a withhold vote against directors in the year after the poison pill is adopted. Now that recommendation will be repeated in future elections if the non-shareholder approved pill is still in place. RiskMetrics has also revised its executive compensation guidelines so that companies with what it considers "poor" pay practices, that also

have a management say-on-pay proposal, will face a RiskMetrics recommendation against approving the say-on-pay but not, as in the past, a withhold vote against compensation committee members. Withhold votes would still be recommended if there is no say-on-pay or if the concerns expressed in previous say-on-pay votes are not addressed. RiskMetrics will also not recommend against approval of equity plans if it determines that non-performance based equity awards are a "major contributor" to the misalignment of pay-for-performance. In evaluating pay-for-performance RiskMetrics has also added an evaluation of total CEO compensation with total shareholder returns over five years. RiskMetrics has added a separate evaluation of policies and practices that could incentivize excessive risk-taking, including analysis of guaranteed bonuses, single-metric performance plans, severance and supplemental pension plans, and large equity grants with no downside risk.

In addition to RiskMetric's new policies, the types of activity likely to result in a withhold recommendation will be similar to past years. The proxy advisory firms frequently recommend withhold votes against directors that sit on the compensation, audit or nominating committees but do not meet the proxy advisor's heightened definition of independence or that sit on the compensation committee of a company with pay practices that do not meet the proxy advisor's expectations. Other frequent triggers are boards that have not implemented shareholder proposals approved by a majority of shareholders, boards that took a controversial action without shareholder approval, directors with poor attendance records at board meetings, and directors that sit on too many public boards.

Changes to the SEC's Comment Process

Shelley Parratt, Deputy Director of the Division of Corporation Finance, indicated in a recent SEC Speech that the Commission has begun to crack down on issuers who fail to comply with its executive compensation disclosure rules, perhaps implying that this would also include the proposed rules to the extent they are adopted. Issuers must start thinking about how to gather the additional information necessary to make the proposed disclosures because, if the proposed rules are adopted, the new disclosures will be of particular interest to the SEC in its reviews.

Ms. Parratt further indicated that after three years of "futures" comments on executive compensation disclosures, the SEC expects companies to understand its rules and apply them thoroughly. Therefore, any issuer who waits until it receives SEC comments before complying with the executive compensation disclosure requirements should be prepared to amend its filings if they are reviewed by the SEC, according to Ms. Parratt. She also said that SEC reviews will be focusing on whether executive compensation disclosures are meaningful and understandable, thoroughly explaining "why" compensation decisions are made when they are mentioned in the Compensation Discussion and Analysis section of the proxy statement.[2]

E-Proxy Amendments

On Oct. 14, 2009, the SEC proposed a series of amendments to its rules requiring Internet availability of proxy materials, often referred to as the e-proxy rules, and provided guidance concerning certain requirements under the present rules.

The proposed rule changes would impact the style and content of the notice of Internet availability (the "Notice") of proxy materials. In addition, the proposals are directed at building sufficient time into the schedule to enable a soliciting person other than the issuer to rely on the notice and access model, taking into account the time frame of an SEC review of the proxy statement.

Changes to Delaware Corporate Law

An important proxy access development for the 2010 proxy season is the adoption of changes to the Delaware General Corporation Law that take a step toward normalizing proxy access concepts:

- Section 112 explicitly allows the adoption of proxy access bylaws and provides a framework for such bylaws. The bylaw can restrict proxy access by, among other things, setting minimum ownership standards and requiring certain information. Certain limitations designed to avoid use of the proxy access bylaw for takeover purposes are also allowed.

2. For example, when a company states that it determined a material element of compensation based on the achievement of performance targets, the S.E.C. will ask for specific disclosure of the targets and the actual achievement level against the targets, or for the company to provide an explanation of how such disclosure would cause it competitive harm. As another example, when a company refers to a peer group used for benchmarking purposes, the S.E.C. will ask for the names of the peer group companies and how they were selected, and where actual awards fell relative to the benchmark. Issuers should take care to address these themes as they draft next year's executive compensation disclosure.

- Section 113 codifies Delaware case law by allowing bylaws that provide for reimbursement of shareholder proxy expenses. Such bylaws can include, among other things, reimbursement restrictions based on the votes received by the nominee or the amount spent by the shareholder. Section 113 also expressly states that any lawful restriction can be included in the bylaw.

The likely impact of Sections 112 and 113 is limited because they are optional, not mandatory, and companies in Delaware and other states arguably have the power to include procedural matters such as proxy access and reimbursement in their bylaws already. Further, until the SEC acts on its proxy access approach, companies will still be able to exclude shareholder proposals for proxy access under past SEC interpretations of the shareholder proposal rules.

Considerations for 2011 Proxy Season and Beyond

Proxy Access

The most significant rule proposal that may be in effect for proxy seasons after 2010 is "proxy access." If adopted, proxy access would constitute a major change in the board election process. This proposal would give certain shareholders the right to have their director nominees included in the company's proxy materials, together with board nominated directors. Under the current regime, a shareholder must go through the effort and expense of a proxy contest to get a director nominee elected over a board nominee. Proxy access removes that significant barrier and would likely result in many more contested elections and successful shareholder nominees. The threat of competing nominees would also give qualifying shareholders a significant new point of leverage in disputes with management.

While some form of proxy access is likely to be either approved by the SEC or adopted by Congress at some point in the near future, the timing and final form of the rules are currently unknown. The SEC reopened the public comment period for its proxy access proposal in December 2009, so it is unlikely that filers will have to confront the issue until 2011 at the earliest.

The SEC has indicated that the delay in its approval process is related to workability issues raised in the comment letters that it has received.[3] To remedy these issues, the SEC may tinker with details or completely re-imagine the proposal. The final rule may, therefore, be a modified version of the original proposal; a proposal to allow shareholders to opt-in to proxy access by submitting proxy access bylaws for shareholder approval on a company by company basis; or some intermediate regime such as instituting proxy access across the board while providing shareholders with a means to opt out.

If a final rule is adopted by the SEC, or if Congress decides to act in the absence of a SEC rule, companies will likely need to amend their bylaws to conform shareholder nomination procedures and provide for any restrictions on the proxy access right allowed by the rule. In light of the current status of this proposal, companies should take a wait and see approach until the timing and details of any final rule become clear.

Pending Federal Legislation

Predicting the outcome on Capitol Hill of any proposed legislation is difficult. Of those bills currently pending that would impact the proxy practices of retail issuers; the primary focus appears to be on increased shareholder input and control. Of primary emphasis are the so-called "say on pay" provisions, which require a non-binding shareholder vote on executive compensation. Corporate governance practices are also addressed, as a number of the bills focus on independence issues relating to boards. While none of the bills listed below have yet been formally enacted (and in fact may not be enacted before they expire at the end of this Congressional legislative session), issuers should nonetheless be aware of the concerns of lawmakers that are represented by these bills in an effort to be proactive with respect to internal policies and practices.

"Corporate and Financial Institution Compensation Fairness Act" (H.R.3269)/ "Wall Street Reform and Consumer Protection Act of 2009" ("Wall Street Reform Act")

H.R.3269, entitled the "Corporate and Financial Institution Compensation Fairness Act," ("3269") which was introduced by House Financial Services Committee Chairman Barney Frank (D-MA) on July 21, 2009. 3269 seeks, among other things, to require a shareholder "say on pay" vote, an annual non-binding shareholder vote approving executive compensation amounts of the company's named executive officers. Such a vote would be truly advisory in nature, and would not overrule any compensation decisions made by the board or any of its committees. Additionally, the vote would have no impact

3. This rule proposal attracted over 500 comment letters during its first comment period, which suggested conflicting revisions to the proposed rule and identified significant issues that the SEC did not address.

on either the fiduciary duties of the board or the ability of shareholders to make proposals related to executive compensation. However, a failed vote would single out a company for the attention of proxy advisors and activist shareholders, resulting in significant pressure to change pay practices.

3269 would also require a non-binding shareholder approval of "golden parachute" compensation. Such compensation is defined by the bill to include any agreements between the company and its named executive officers concerning compensation relating to a merger, acquisition, consolidation, sale, or other disposition of all or substantially all of the assets of the company. 3269 requires that the company disclose all golden parachute compensation agreements to its shareholders in a clear and simple form in accordance with regulations to be promulgated by the SEC. Again, such vote would have no direct impact on the decisions made by the board, nor would it create or alter any existing fiduciary duty owed by the board to the company, but it could result in the indirect pressures discussed above.

Additionally, 3269 would require any institutional investment managers to disclose each year how they have voted on any of the say on pay or golden parachute shareholder votes contemplated by the bill.

With respect to corporate governance, 3269 contains provisions that allow a company's compensation committee to obtain the advice of an outside compensation consultant, provided that the consultant meets the standards for independence set forth by the SEC. Standards for independence would be set by the SEC following the passage of the bill, but the bill mandates that such standards be "competitively neutral." If a company's compensation committee does seek the opinion of a consultant, the committee is required under 3269 to disclose this fact. The consultant's opinion may not be binding on the committee or otherwise affect the committee's ability to exercise its own independent judgment.

Further, 3269 requires that all compensation committee members also be independent. In order to be considered "independent" under 3269, compensation committee members may not, other than in his or her capacity as a member of the compensation committee, board of directors, or other board committee, accept any sort of compensatory fee from the company (whether consulting, advisory or other fee).

With respect to all provisions of 3269, the right of the SEC to exempt certain categories of issuers from its terms is expressly reserved. The bill expressly states that the SEC shall consider the impact of 3269 on smaller issuers when considering exemptions.

As of the time of publication of this article, 3269 has been passed in the House of Representatives and introduced in the Senate, where it has been referred to the Committee on Housing, Banking and Urban Affairs.

The exact provisions of 3269 have, however, found their way into a massive reform bill that appears to be garnering significantly more political attention. In early December, 2009, Chairman Barney Frank introduced a massive piece of financial reform legislation, the "Wall Street Reform and Consumer Protection Act of 2009" (the "Wall Street Reform Act"). Among other things, the Wall Street Reform Act proposes sweeping reforms to financial services and institutions as well as efforts to improve consumer and investor protections. The Wall Street Reform Act consolidates proposals contemplated by numerous bills that had been previously introduced in the House and Senate, including, among others, 3269. Title II of the Wall Street Reform Act is also entitled the "Corporate and Financial Institution Compensation Fairness Act," and mirrors in every way the exact provisions of 3269. As of the time of publication of this article, the Wall Street Reform Act has been passed in the House and will now be considered by the Senate.

If either 3269 or the Wall Street Reform Act is passed by the Senate and signed into law, their provisions require the SEC to enact say on pay regulations no later than within six months of the date of such passage. The bills further dictate that any such regulations shall apply to any annual meeting or special meeting occurring six months or more after the final regulations are issued. Thus, even if the bills are enacted prior to the adjournment of the current legislative session, their provisions would likely not impact the 2010 proxy season. No deadline for enactment of the corporate governance provisions is provided by the bills.

"Shareholder Bill of Rights Act of 2009" (S.1074)

S.1074, the "Shareholder Bill of Rights Act of 2009," ("1074"), was introduced by Charles Schumer (D-NY) on May 19, 2009. Like the bills discussed above, 1074 seeks to require annual non-binding say on pay and golden parachute shareholder votes. As was the case with 3269 and the Wall Street Reform Act, such votes would not directly impact the board's compensation decisions, nor would they impose addi-

tional fiduciary duties on the board or impact the shareholders' ability to make proxy proposals related to executive compensation. The same indirect effects would apply, however.

Also like the bills discussed above, 1074 speaks to corporate governance and director independence issues. However, the substance of such provisions is notably different from 3269 and the Wall Street Reform Act.

Regarding director independence, 1074 seeks to require that the chairperson of the board of directors be independent (as determined by the rules of the exchange upon which securities of the company are listed), and shall not have previously served as an executive officer of the company.

1074 bolsters the SEC's legal basis for instituting proxy access by rule by confirming the authority of the SEC to establish rules regarding the use by shareholders of proxy materials provided by the company in nominating individuals for director elections. To qualify for use of proxy materials, a shareholder (or group of shareholders) must have beneficially owned not less than one percent of the issuer's securities for at least the two year period preceding the date of the issuer's next annual meeting.

1074 would also institute mandatory majority voting by requiring that in board elections, directors in uncontested elections shall be elected by a majority of votes cast. In contested elections, a plurality of the shares represented and entitled to vote will suffice to elect a director. If a director is not properly elected in accordance with these provisions, such director shall tender his resignation to the board, and the company shall accept the resignation and determine (and make public) a date on which such resignation shall take effect, which shall be "within a reasonable time" as established by the SEC. The provisions of 1074 reflect an effort to bind the company to the results of a shareholder election and curb company practices of retaining those directors who fail to receive a true majority of support from shareholders. 1074 would also eliminate the concept of "staggered boards" that a number of companies currently employ. Under the provisions of the bill, companies must hold elections for every board position on an annual basis.

Also included in 1074 is the requirement that companies establish a "risk committee" comprised of independent directors, the primary duty of which would be to establish and evaluate the company's risk management practices. Rules governing these risk committees would be promulgated by the SEC within one year after the date of passage of the bill.

The bill provides that no later than one year after the bill's passage, the SEC shall promulgate rules requiring the national securities exchanges and associations to prohibit the listing of any security of a company that fails to comply with any of its provisions. As of publication, 1074 has been introduced in the Senate and referred to the Committee on Banking, Housing, and Urban Affairs.

"Shareholder Empowerment Act of 2009" (H.R.2861)

H.R.2861, entitled the "Shareholder Empowerment Act of 2009," ("2861") was introduced by Gary Peters (D-MI) on June 12, 2009. 2861, like the other bills discussed, would require a non-binding say on pay shareholder vote on executive compensation of senior executive officers. Also like the other bills, this vote would not directly impact the decision of the board, nor would it affect the fiduciary duties of the board or the ability of shareholders to introduce proposals related to executive compensation.

Where 2861 differs from other legislation is in its recoupment provisions. 2861 seeks to require the recoupment, or "clawback," of unearned performance-based payments to management. Under the proposed legislation, the board of directors (or a committee thereof) is required to develop and publish a policy for reviewing unearned bonus or incentive payments that were awarded to executive officers because of fraud or financial results that are later restated or revised. Such policy shall require recovery or cancellation of any such payments. A number of companies have already enacted such policies; however, up until this point companies have not been required to do so.

Included in 2861 is the requirement that the SEC promulgate regulations that would require securities exchanges and associations to prohibit the listing of any securities of a company that fails to comply with the recoupment policy requirement. The bill also requires that the SEC enact rules requiring companies to disclose those performance targets upon which bonuses or other incentive compensation is based.

Additionally, 2861 touches on severance agreements, prohibiting any such agreements that would offer payments to a senior executive officer who is terminated because of poor performance. To the extent that the executive officer is terminated for cause, the company could potentially still pay com-

pensation under a severance agreement. However, 2861 states that poor performance is a factor that should be considered by the company's board in determining whether any severance payment is in fact made.

With respect to corporate governance concerns, 2861 contains majority vote requirements for directors in uncontested elections similar to 1074 above. 2861 would require companies to adopt an internal policy that calls for the resignation of any director who fails to receive a majority of votes in an uncontested election. However, unlike the draconian provisions of 1074 (which require not only the resignation of the director, but also acceptance by the company), 2861 would allow companies a measure of discretion in whether or not to accept the resignation. The board of directors (or a committee thereof) has the authority to determine which action to take regarding such resignation, and once a determination is made, the board must publicly disclose its decision and the rationale within a reasonable time.

2861 also requires the SEC to enact "proxy access" rules. 2861 would require companies to identify and provide shareholders with an opportunity to vote on candidates for the board who have been nominated by holders of at least one percent of the company's stock for at least two years prior to a record date set by the company. The rules shall specify what information is to be provided by shareholders who are nominating candidates, and shall require the company to disclose that information in the proxy materials to the same extent the company is required to make disclosures about its own candidates. Such rules shall only apply when eligible shareholders have nominated less than a majority of the number of directors. The proxy access rules would apply to all proxy voting for meetings held on or after Jan. 1, 2010, except to the extent that a meeting was originally scheduled to be held in 2009, but was adjourned to 2010.

Similar to 1074 are provisions that require an independent chairman of the board of directors. However, 2861 contains a list of specific factors that would destroy such independence, including:

- If the individual was employed by the company in an executive capacity;
- If the individual is/was an employee, director or owner of a firm that is a paid advisor or consultant to the company;
- If the individual is/was employed by a customer or supplier of the issuer;
- If the individual is/was party to a personal services contract with the company (or the company's chairperson, CEO, or other senior executive officer);
- If the individual is/was an employee, director or officer of a non-profit organization that receives a threshold amount of donations from the company;
- If the individual is/was a relative of an executive;
- If the individual is part of an "interlocking directorate," in which the company's CEO or other executive serves on the board of another company employing that director; or
- If the individual is engaged in any other relationship with the company or senior executives that the SEC determines would destroy independence.

As of the time of publication of this article, 2861 has been introduced in the House and referred to the House Committee on Financial Services for consideration.

"Excessive Pay Shareholder Approval Act" (S.1006)

S.1006, the "Excessive Pay Shareholder Approval Act," ("1006"), introduced by Senator Richard Durbin (D-IL) on May 7, 2009, seeks to require a supermajority shareholder vote to approve excessive compensation for any employee of a publicly traded company. The bill requires that the compensation for an employee of a company in any single taxable year not exceed an amount equal to 100 times the average compensation for services performed by all employees of that company during such taxable year, unless at least 60 percent of the shareholders of the company have voted to approve such compensation. The proxy materials for such a vote shall include:

- The amount of compensation paid to the lowest paid employee of the issuer;
- The amount of compensation paid to the highest paid employee of the issuer;
- The average amount of compensation paid to all employees of the issuer;

- The number of employees of the issuer who are paid more than 100 times the average amount of compensation for all employees of the issuer; and

- The total amount of compensation paid to employees who are paid more than 100 times the average amount of compensation for all employees of the issuer.

The bill provides that "compensation" includes all wages, salary, fees, commission, fringe benefits, deferred compensation, retirement contributions, options, bonuses, property, and any other remuneration that the SEC determines is appropriate, with input from the Secretary of the Treasury.

If 1006 is passed, the SEC shall promulgate final rules within one year following such passage. As of the time of publication of this article, 1006 has been introduced in the Senate and referred to the Committee on Banking, Housing, and Urban Affairs for consideration.

"Excessive Pay Capped Deduction Act of 2009" (S.1007)

S.1007, the "Excessive Pay Capped Deduction Act of 2009," ("1007"), was introduced by Senator Richard Durbin (D-IL) on May 7, 2009. The bill seeks to amend the Internal Revenue Code and disallow deduction for any excessive compensation for any employee of a taxpayer. "Excessive compensation" is defined to include the amount by which the compensation for services performed by such employee during the taxable year exceeds the amount which is equal to 100 times the amount of the average compensation for services performed by all employees of the taxpayer during the taxable year.

If passed, 1007 shall apply to all taxable years beginning after the date of such passage. As of the time of publication of this article, 1007 has been introduced in the Senate and referred to the Committee on Finance.

Draft Federal Legislation

"Restoring American Financial Stability Act of 2009" (Dodd Draft)

On Nov. 11, 2009, Senator Chris Dodd (D-CT) circulated a discussion draft of a proposed bill (the "Dodd Draft") that, while focused mainly on financial service providers, also contains provisions that could impact the business of all public companies in the United States. In many respects the Dodd Draft is similar to Senator Schumer's 1074 bill discussed above.

Like 1074, the Dodd Draft seeks to require majority voting in uncontested director elections. Any director who fails to receive the requisite majority would be required to submit his or her resignation. However, the Dodd Draft differs from 1074 in that it provides the board of directors with the option to refuse such resignation upon a unanimous vote. A decision to refuse a resignation (as well as the reasoning for doing so) must be made public by the issuer within 30 days of such decision (or such other period as set by the Commission).

While 1074 would require all public companies to have risk committees, the Dodd Draft limits such application to publicly traded bank holding companies with assets over $10 billion. Thus, public companies outside of the bank holding arena would not be required to maintain such a committee.

The Dodd Draft also proposes proxy access rules. Under its provisions, the Commission would be required to issue regulations permitting shareholders to use proxy solicitation materials supplied by the issuer for the purpose of nominating director candidates. Unlike 1074, however, the Dodd Draft contains no share percentage ownership requirement, which in turn provides the right to proxy access to all shareholders who nominate director candidates.

Also similar to 1074, the Dodd Draft contemplates the notion of annual election of directors. Under its terms, issuers would be prohibited from maintaining boards with staggered terms unless the shareholders approved the arrangement. The provisions of the bill mandate that the shareholder vote required to approve a staggered board arrangement be the same as the vote required to amend the issuer's governing document that provides for the staggered board. If a company were to maintain a staggered board without shareholder approval as described in the Dodd Draft, the provisions of the bill would seek to require national securities exchanges to delist the securities of such companies.

Like other bills, the Dodd Draft also seeks to require nonbinding shareholder say on pay votes. Also like other bills, the Dodd Draft proposes to limit golden parachute payments, requiring that proxies solicited in connection with any business combination transaction disclose any compensation arrangements related to the transaction between target executives and the issuer.

The Dodd Draft seeks to require that the compensation committees of all listed companies be comprised only of independent directors. Any consultants, legal counsel, or other advisers engaged by the compensation committee must also be independent. Like 3269 and the Wall Street Reform Act above, the Dodd Draft provides that the compensation committee has the ability to seek assistance from a compensation consultant, but also requires certain additional disclosures by the issuer related to the compensation consultant (including whether or not such a consultant was engaged by the committee).

Clawbacks are also addressed by the Dodd Draft, which mandates that issuers adopt such policies for current and former executive officers. Under the provisions, a clawback of compensation would be triggered by a material non-compliance with financial reporting requirements by the company that leads to a restatement. The policies must apply to the three-year period preceding the restatement.

The proposed Dodd Draft would also require disclosure of the relationship between the issuer's executive compensation and financial performance, including use of a graphic or pictorial comparison of the amount of executive compensation compared with the financial performance of the company or return to investors. Further, the Dodd Draft asks that the Commission promulgate regulations that would require issuers to disclose in their annual proxy statement why certain individuals have been chosen to serve as chairman and CEO of the company.

While quite broad in scope, it should again be noted that the Dodd Draft has not yet been formally introduced in the Senate. When and if such introduction should occur, the bill will likely undergo substantial changes in an effort to eliminate overlap between it and other pending legislation.

Waters Amendment to the Investor Protection Act

In November of 2009, Representative Maxine Waters (D-CA) introduced an amendment to the Investor Protection Act of 2009 (H.R.3817) that seeks to clarify the authority of the SEC to issue rules on shareholder access to an issuer’s proxy. While the Waters amendment in no way obligates the SEC to take action to promulgate proxy access rules, it represents an effort on the part of lawmakers to clarify that the Commission does in fact have the authority to do so. The House Financial Services Committee approved the Waters amendment, and on Nov. 4, 2009, approved H.R.3817. As of the time of publication of this article, the bill had yet to be considered by the full House of Representatives.

CHECKLISTS

2010 Proxy Season

Board governance disclosures -

- ☑ explain how governance structure best serves the company
- ☑ explain how the board manages company risks
- ☑ justify the selection of board members and nominees by explaining their contributions to the board
- ☑ evaluate the role of diversity in the board selection process

Compensation committee action items -

- ☑ address relationship between incentive compensation and company risks
- ☑ disclose potential conflicts of interest for compensation consultants

Election contests and shareholder voting -

- ☑ consider the impact that losing broker non-votes will have and take action to mitigate (e.g., adding routine items, foregoing notice-and-access e-proxy)
- ☑ be prepared for greater levels of shareholder activism (proposals, contested elections) with stronger support from proxy advisors

2011 Proxy Season

Proxy access -

- ☑ evaluate SEC rules when they become final
- ☑ consider amending company bylaws and taking other steps to mitigate impact (advance notice/disclo -sure bylaws)
- ☑ be ready for board contests by ensuring board competence and communicating it to shareholders

Say-on-Pay -

- ☑ communicate, communicate, communicate - how is pay linked to performance?
- ☑ evaluate your processes for setting compensation - are they rational, reasonable, and appropriate for the business

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