

**NATIONAL INVESTOR RELATIONS
INSTITUTE, SEATTLE CHAPTER**

RECENT SEC DEVELOPMENTS

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A. **Renewed Scrutiny of Executive Compensation**

1. **Disclosures in 2009 Proxies and Reports**

Executive compensation will again be a “hot topic” for the 2009 proxy season. Companies will want to refine and improve their compensation disclosure as they approach the third year of compliance with the SEC rules, as interpreted by the SEC staff. Some of the key considerations are:

- **Performance targets.** Companies need to analyze carefully whether to disclose specific performance targets for 2008 and for future years. If these targets are material to the company’s executive compensation policies and decisions, they are subject to disclosure under Rule 402, Regulation S-K, unless it would reveal confidential commercial or financial information or trade secrets and result in competitive harm to the company. The SEC’s Division of Corporation Finance recently stated that the test for “competitive harm” is whether a third party could use the targets to extrapolate information regarding the company’s business or strategy and use it to the company’s disadvantage.
- **Analysis.** Companies should review and revise their CD&A to improve disclosure on how and why their compensation committee arrives at specific executive compensation decisions and policies, with less emphasis on compensation program mechanics and decision-making procedures.
- **Benchmarks.** Companies using benchmarks to set pay should disclose more fully any benchmarks and how they are used, and explain in detail why the peer companies chosen are appropriate for their business and compensation. The Division recently advised that the term “benchmarking” generally refers to the use of compensation data from other companies “as a reference point on which – either wholly or in part – to base, justify or provide framework for a compensation decision.” Simply reviewing broad-based surveys generally is not considered “benchmarking.”
- **Change in control arrangements.** Companies should discuss more extensively the rationale for entering into agreements that provide change in control benefits and how these arrangements fit within overall pay practices and philosophy.

- **Consultant's role.** Disclosures regarding the compensation committee must include a discussion of any role of compensation consultants in setting executive or director compensation; however, the Division advised that CD&A should discuss the consultant's role only if it was material in the compensation-setting process.

2. Emergency Economic Stabilization Act of 2008

In response to the financial crisis affecting the banking system and financial markets, the Emergency Economic Stabilization Act of 2008 (the "Act") was enacted on October 3, 2008. Public and privately-held companies who participate in certain programs under the Troubled Asset Relief Program (TARP), administered by the U.S. Treasury Department, including the Capital Purchase Program and the Troubled Asset Program, are subject to certain additional restrictions with respect to their executive compensation plans, agreements and policies. For example, the Capital Purchase Program imposes the following requirements with respect to the CEO, CFO and next three highest compensated executives ("senior executives"):

- Incentive compensation arrangements must not encourage executives to take excessive risks that threaten the financial health of the company.
- Bonuses and incentive pay that were based on financial statements that were materially inaccurate must be subject to clawback provisions. The Sarbanes-Oxley Act of 2002 also included a clawback provision for CEOs that is limited to restatements of financial results.
- The company is prohibited from making golden parachute payments to the executives, under §280G of the Internal Revenue Code, as amended by the Act to cover all involuntary terminations and terminations in connection with bankruptcy, liquidation, or receivership of a company.
- The company may not deduct executive compensation per individual in excess of \$500,000 (instead of \$1,000,000), under §162(m) of the Code, as amended by the Act.

Many believe that some or all of these provisions may eventually be applied by the federal government in other contexts by legislation or regulation.

3. Amendments to Company Plans and Agreements to Comply With Section 409A of the Internal Revenue Code

(a) Coverage: In 2007, the IRS issued final regulations interpreting §409A of the Code, restricting so-called “nonqualified deferred compensation arrangements” with employees and other service providers, including directors.

Section 409A applies not only to written traditional nonqualified deferred compensation plans such as bank-owned life insurance or BOLI plans and supplemental executive retirement plans or SERPs, but also to change of control agreements, employment and consulting agreements, discounted stock options and SARs, severance arrangements, salary and bonus deferral plans and agreements, cash and equity incentive plans (including restricted stock units and performance shares), and even certain expense reimbursement arrangements and informal practices or policies that result in a deferral of compensation.

The regulations generally require all nonqualified deferred compensation arrangements to be in writing, and drafted to strictly comply with §409A by December 31, 2008.

(b) Six Months’ Waiting Period for Public Companies: Payments of deferred compensation made in connection with a “key employee’s” termination of employment from a company whose stock is “publicly traded” – defined by the regulations as any company whose stock is “traded on an established securities market or otherwise” – are subject to a special 6-month waiting period under §409A that must be written into the plan or agreement. Generally, “key employees” are the top 50 officers earning more than \$150,000 in 2008 (indexed annually for cost of living), a 5% shareholder, or a 1% shareholder earning more than \$150,000.

(c) Penalties: Failure to comply with §409A may subject executives to the inclusion in income of all previously deferred amounts plus interest and a 20% penalty tax. Companies may also face tax reporting and withholding penalties.

(d) Amend Arrangements to Bring Them Into Compliance with §409A: Most, if not all employment agreements, severance arrangements and change of control agreements (including plans and agreements that were amended based on the proposed regulations) will require, at a minimum, the following changes by year-end:

- Specify the amount, timing and events for all payments and the conditions for any deferral or distribution elections, consistent with the regulations.

- Revise definitions of “change of control,” “good reason,” “disability” and “termination of employment” to conform to the regulations and consider adopting the regulations’ safe harbor for “good reason” termination in change of control payment provisions.
- Include the 6-month delay requirement for key employees.

In addition, all stock option and SAR plans must be examined to confirm that they do not permit discounted options or awards, and amended as necessary so that the “fair market” stock valuation and exercise provisions of the plan and agreements conform to the regulations for valuing the stock of public companies based on market transactions.

Notably, a stock price based on an average of up to 30 days may be used to establish the fair market value exercise price, but only if the commitment to grant the stock right on a particular date is irrevocable before the valuation period begins. To satisfy this requirement, the executive must designate the recipient of the stock right, the number of shares subject to that right, and the method for determining the strike price, including the period over which the averaging will occur, prior to the beginning of the measurement period.

Certain amendments may have to be approved by the company’s board of directors, and new or materially amended stock plans require notices and shareholder approval under stock exchange rules.

B. Modernization of Disclosure Requirements

1. SEC Guidance on Use of Company Websites.

In August 2008, the SEC Staff published an interpretive release providing guidance on the use of company websites under the Securities Exchange Act of 1934 and the antifraud provisions of the securities laws. The release is part of the SEC’s continued efforts to promote the use of company websites to disseminate information to investors.

(a) Information Posted on Company Websites May Be Used to Comply with Regulation FD Requirements: The SEC has clarified in its release that if the information on the company website is deemed public (based on a consideration of various criteria discussed below), then subsequent selective disclosure of that information to an analyst or in a private conversation would not trigger Regulation FD’s public disclosure requirement. In addition, if a company makes selective disclosure, subsequent posting of the information on the company website could satisfy the simultaneous (in the case of intentional disclosure) or prompt (in the

case of unintentional disclosure) public disclosure requirement under Regulation FD and serve as an alternative to filing a current report on Form 8-K, issuing a press release or using other methods of disclosure designed to provide broad distribution of information to the public.

- The release sets forth three considerations to help determine whether information posted on company websites is considered “public”:
 - ➔ Whether a company’s website is a “recognized channel of distribution.”
 - ➔ Whether information is posted in a manner calculated to reach investors.
 - ➔ Whether information is posted for a reasonable period of time to be absorbed by investors. Typically, larger companies allow at least one full trading day after the release of information, and smaller companies allow at least two full trading days.
- The SEC lists eight non-exclusive factors in an effort to help companies determine if they comply with the first two considerations, which companies desiring to take advantage of the new guidance should review carefully in designing or enhancing their websites:
 - ➔ Including the company’s domain name in all press releases and SEC filings.
 - ➔ Search engine optimization/visibility of the company’s website.
 - ➔ Adding a sentence in all investor-related documents that the “company routinely posts all important information on its website.”
 - ➔ Revising company’s disclosure controls to ensure that all financial news is promptly posted on their website and readily accessible.
 - ➔ Maintaining and updating the site regularly to stay current and accurate.
 - ➔ While the SEC clarified that information need not be “printer-friendly,” unless required by other SEC rules (e.g., ethics codes and committee charters), it is desirable.
- Companies should continue to file Form 8-Ks, and post news releases on their website, for significant information.
- Large companies like General Motors, Exxon/Mobil and Dell have model websites worth visiting for their investor-friendly design and prominent “investor links.”

- Smaller companies may have difficulty meeting the following non-exclusive factor in the release, which could use further clarification: “The extent to which information posted on the company’s website is regularly picked up by the market and readily available media, and reported in such media or the extent to which the company has advised newswires or the media about such information, and the size and market following of the company involved.”
- Finally, another non-exclusive factor listed by the SEC encourages the use of so-called “push” technology, such as e-mail alerts and RSS feeds, or releases through other distribution channels to widely distribute information or advise the market of its availability.

(b) Antifraud Provisions of the Securities Laws Apply to Information Posted on or Hyperlinked to Company Websites: The antifraud provisions of the federal securities laws, which prohibit making material misstatements and omitting material facts in connection with the purchase or sale of securities, apply to information posted on or hyperlinked to a company website. Therefore, companies must ensure the accuracy of such information.

A company can also be held liable for third-party information that it has hyperlinked to its website, if the company was involved in its preparation or endorsed such information. “Exit notices” or “intermediate screens” leading to hyperlinked information may not shield a company from antifraud liability. Further, disclaimers as to the accuracy of the third-party information will not insulate a company from antifraud liability if the company knows or is reckless in not knowing that such third-party information is materially false or misleading.

As companies are making greater use of interactive website features such as “blogs” or the “electronic shareholder forums” encouraged by the SEC in its November, 2008 amendments to the proxy rules, the SEC warns that companies should have appropriate controls and procedures to monitor statements made by or on behalf of companies on their blogs or forums, because the antifraud provisions of the securities laws apply to these channels of communication. In addition, the SEC clarified that companies may not have investors waive federal securities laws protection as a condition of using a blog or a forum.

(c) Disclosure Controls and Procedures Apply to Certain Information Posted on Company Websites: The required certifications by a company’s principal executive officer and principal financial officer in its 10-Qs and 10-K that they have evaluated the

effectiveness of the disclosure controls and procedures cover information disclosed on the company website as an alternative to providing the required disclosure in an Exchange Act report or proxy statement filed with the SEC.

C. Shareholder Activism

With the bear market, the 2009 proxy season is likely to be even more active and contentious than in previous years, particularly those shareholder proposals focusing on executive pay and “vote no” campaigns for certain directors.

1. Internet Usage

Activist shareholders could use a company-sponsored forum to organize a campaign to gain majority support on issues such as executive compensation, majority voting for directors, “withhold” votes for specific directors, and other hot proxy issues. An individual investor used his blog and videos posted on YouTube to orchestrate a campaign that resulted in a 33 percent “against” vote for seven of the 10 Yahoo directors at the company’s 2007 annual meeting, and forced the departure of its CEO.

2. Handling Shareholder Proposals

On November 7, 2008, the SEC’s Division of Corporate Finance issued Staff Legal Bulletin No. 14D, regarding the shareholder proposal process under Rule 14a-8 of the Securities Exchange Act of 1934:

- Confirming that if a proponent is listed in a company's records as a registered holder, but those records indicate that the proponent has not owned the minimum amount of securities for the required time period, the company must send the proponent a notice of defect if it wishes to exclude the proponent’s proposal on eligibility grounds.
- Clarifying that the Division may permit a proponent to avoid exclusion of a proposal that recommends, requests, or requires that the board of directors make a change (e.g., cumulative voting) that the board is unable to do on its own – such as amending the company’s articles of incorporation, which requires both board and shareholder action – by allowing the proponent to revise the proposal to provide that the board “take the steps necessary” to effect the requested action.
- Allowing companies and shareholders to e-mail the Division Rule 14a-8 no-action requests and related correspondence at shareholderproposals@sec.gov.

- Clarifying that Rule 14a-8 requires proponents to provide companies with correspondence they send to the Division. In addition, both the company and the proponent should promptly forward to each other copies of all correspondence provided to the Division in connection with Rule 14a-8 no-action requests.

D. Other News

1. Suspension of NASDAQ's Minimum Bid and Minimum Value of Public Float Rules

On October 16, 2008, NASDAQ suspended through January 16, 2009, the application of its requirements for continued listing on the NASDAQ Stock Market under which companies are subject to delisting for (i) failing to maintain at least a \$1 closing bid price for 30 consecutive business days, and (ii) under the minimum value of public float rules, for failing to meet requirements for the minimum market value of publicly held shares for 30 consecutive business days.

In suspending these rules, NASDAQ cited the recent unprecedented market turmoil, the recent increase in the number of NASDAQ-listed companies trading below \$1 per share, and its desire to restore investor confidence.

During the temporary suspension of these requirements, Nasdaq intends to consider whether it is appropriate to propose further revisions to its requirements.

2. Auditor Attestation Report on Internal Controls Over Financial Reporting Under SOX §404

- Delayed (again) for non-accelerated filers to 10-Ks for fiscal years ended on or after December 15, 2009.

E. What's Next?

With the recent turmoil in the credit and financial markets, the downturn in the economy, and the new Democratic administration, financial institutions especially, and many other public companies can expect:

1. More Regulation and Governmental Intervention

- Federal and state regulators will focus on these areas:
 - ➔ Risk management
 - ➔ Legal and regulatory compliance

- ➔ Internal controls and procedures to detect and prevent fraud by employees, vendors or customers
- ➔ Further regulation of new, complex financial products, including derivatives, and off-balance sheet transactions for which there will be accounting changes
- ➔ New federal regulations of hedge fund, insurance and other financial and investment industries such as insurance
- Insider trading investigations, enforcement and controls for the release and dissemination of information to investors, including the recent fallout from executives' pledged securities sold to meet margin calls.
- Restrictions and limitations with respect to executive compensation, focusing on the use of clawbacks, excessive pay, and pay structures that encourage excessive risk-taking.
- SEC investigations and enforcement actions into the use of false information and short-selling with the intent to manipulate market prices, and compliance with the new rules and reporting obligations for investment managers (Regulation SHO).
- Probable expansion of TARP to other industries (e.g., insurance, credit cards, auto industry).

2. Effects on Companies

- Companies will likely be focusing on these areas:
 - ➔ Complying with new laws and regulations
 - ➔ Dealing with disappointed institutional and other shareholders, including potential proxy contests (which are popular again – Atmel, NRG, Yahoo) and increased shareholder activism with the encouragement of the SEC
 - ➔ Industry consolidation/mergers
 - ➔ Dealing with companies' underwater stock options/plans
 - ➔ Devising new performance-based equity-based stock options and incentives to retain and motivate executives

Reasons for the shift from traditional service-based options include the adoption of FAS 123R, which eliminated the advantage of stock options under accounting rules, publicity about stock option abuses, backdating, disproportionate compensation (Enron, WorldCom, Tyco, in the

early 2000s), institutional investor and shareholder activism and preferences. Like the market volatility in the early 2000s, the market volatility today as a result of the credit and financial crisis, is again generating concerns about executive compensation, equity-based incentives, and “underwater” options and incentives and what to do with them.

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