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SEC Enforcement: A Year in (P)review

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We took risks, we knew we took them; things have come out against us, and therefore we have no cause for complaint.

One would be hard-pressed to find a more apt description of the financial crisis of the past year. Oddly enough, however, these words were not gleaned from accounts of the current meltdown in the markets. Rather, they were discovered scrawled as a "Message to the Public" in the diary of famed British explorer Robert F. Scott after his ill-fated attempt to lead the first expedition to the South Pole in 1912.

In more ways than one, the recent financial crisis has invited a similar sort of anticipatory sculpting of history. From executives to enforcement authorities, there has been a rush to end up on the right side of history when the tumult finally comes to an end. This article tracks some of the more salient developments in the area of securities enforcement over the past year and attempts to forecast how these developments may continue in the year-to-come. In doing so, it attempts to identify trends that may figure heavily in the priorities of enforcement authorities as the fallout from the financial crisis continues and the chorus of demands for an explanation and a plan to prevent a reoccurrence grows louder.

FY 2008: Lasting Trends

Most any account of the Securities and Exchange Commission's enforcement program in FY 2008 will include a recital of the Commission's quantitative accomplishments for the year.[1] With a record number of insider trading cases and a substantial number of enforcement cases overall, the Commission's notable's successes were in cases focused on insider trading and illegal market transactions by high-level market participants. The Commission's attempt

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From the EDITORS

To Sue or Not to Sue, Institutional Investors Ponder the Question

NEW YORK—One of the most important questions plaintiffs' counsel can ponder is whether or not to pursue litigation against a company on behalf of shareholders. So important is this question that lawyers representing several large institutional shareholders (who might have to examine this question dozens of times each month), gathered together recently to discuss it.

At panel entitled, "To Litigate or Not?"—part of a conference here on Global Shareholder Activism held Dec. 4-6 and sponsored by plaintiff law firm Grant & Eisenhofer—institutional investors' counsel chewed over the ins and outs of bringing litigation.

David Muir, chief counsel of the Los Angeles County Employees Retirement Association (LACERA) said pursuing litigation can be a "fiduciary obligation" in some cases. "It's getting harder and harder to not get involved (in litigation)," Muir told the group. "It's very dangerous to just sit back and not do something, or not pay attention to cases." LACERA oversees more than $40 billion in pension and retirement funds of L.A. County.

Greg Smith, general counsel for the Public Employees' Retirement Association of Colorado (PERA), said in some cases it's easy to know whether to litigate. "Insider trading cases, any case where someone took money from us and we want to get it back, or any case where we might have an issue that no one is addressing—those are easy ones to decide," Smith explained. Harder, though are cases that may not be so clear cut. In deciding to bring a case against Royal Ahold NV, Smith said PERA wanted to send a message to the boards of foreign companies that fraudulent activity would not be tolerated wherever it occurs.

Like many institutional investors, Colorado's PERA, which oversees about $41 billion in assets, has installed a new policy to help decide when the fund will pursue litigation. PERA's policy sets a minimum loss threshold and urges litigation in cases where the outcome may have a deterrent effect on future behavior. "With policies such as these in place, we can really examine if bringing litigation is the best use of PERA's resources," Smith said.

"A fund's investment is an asset like anything else," Smith said. "And an asset has to be managed and cared for." And sometimes that means legal pursuit of those who may have damaged the asset.

In this issue… The December/January issue of *Securities Litigation Report*—the combined last issue of 2008 and the first of 2009—takes a long look at the past year in SEC enforcement. Author Elizabeth P. Gray of Willkie Farr & Gallagher LLP examines the Securities and Exchange Commission's enforcement record looking back over the past year and looking ahead to the coming year. With insider trading making a comeback in 2008 as a source of SEC enforcement action, and regulators looking at possible criminal causes of the current market meltdown, the coming year is likely to bring more enforcement efforts.

Also in this issue, author William D. Johnston, of Young Conaway Stargatt & Taylor, LLP, brings readers up to date on the issue of "advancement"—companies' ability or obligation to advance defense costs to directors or officers involved in litigation. Two recent cases, the author argues, have emphasized the importance of counsel paying close attention to this issue.

Calling for stories… *Securities Litigation Report* always is looking for interesting story ideas concerning the ongoing markets crisis, new litigation trends, recent court decisions and the latest developments. If you or someone at your firm has an idea for an article—please contact our managing editor, Gregg Wirth, at gregg@gwirth.com.

—JOSEPH M. MCLAUGHLIN & GREGG WIRTH

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to reign in misconduct by hedge funds was also a theme throughout the year, as was aggressive enforcement of the Foreign Corrupt Practices Act. Throughout the year, the SEC's continued its commitment to working in tandem with criminal authorities to prosecute securities fraud.

Insider Trading

This past fiscal year saw an unprecedented number of insider trading cases brought by the SEC, with an increase of 25% from the previous year.[2] Perhaps more significantly, the SEC continued to pay increased attention to insider trading involving hedge funds, a focus which may well have peaked in March 2007 with the filing of *SEC v. Guttenberg et al.*[3] In *Guttenberg*, the SEC alleged that 14 defendants, both individuals and hedge funds, were involved in insider trading schemes for the better part of five years. These schemes consisted of hundreds of tips, over $15 million in illegal trading profits, and the involvement of insiders at UBS Securities LLC and Morgan Stanley & Co., Inc.

In its complaint, the Commission alleged that from 2001 through 2006, Mitchel S. Guttenberg, an executive director in the equity research department of UBS, tipped material, nonpublic information concerning imminent upgrades and downgrades to two Wall Street traders, Erik R. Franklin and David M. Tavdy, in exchange for sharing in the profits from their trading on that information. In turn, Franklin and Tavdy tipped their own downstream tippees who also traded on the information. The complaint alleged that from 2005 to 2006, an attorney in Morgan Stanley's global compliance department, together with her husband, also an attorney, tipped material, nonpublic information concerning upcoming corporate acquisitions involving Morgan Stanley's investment banking clients to a registered broker in Florida in exchange for sharing in his illicit trading profits. The broker himself had several downstream tippees who traded on the information.

As the *Guttenberg* case drew to a close, it served as a reminder of what likely informed the SEC's priorities with respect to insider trading over the last year. In addition to the focus on hedge funds, which has been the subject of much discussion since 2005, *Guttenberg* signaled a focus on the conduct of high-ranking market professionals that continued throughout this past year. Indeed, in speaking about the *Guttenberg* case, Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, stated that it was "particularly pernicious when Wall Street insiders—who derive their already substantial livelihood from the capital markets and those markets' investors—shamelessly compromise the markets' integrity and investors' trust for a quick buck."[4]

Building on *Guttenberg*, the Commission continued its focus on pursuing insider trading case involving industry professionals as well as prominent executives this year with a number of high profile filings.

In January 2008, the Commission filed an insider trading complaint, *SEC v. Raben et al.*, against two former employees of PriceWaterhouseCoopers LLP, alleging that the pair had used sensitive information that they had access to as a result of their positions in the accounting firm to buy stock ahead of a series of corporate takeovers.[5] Less than a month later, the Commission announced that it had settled a case involving a former Dow Jones & Co. board member and three other Hong Kong residents accused of illegal tipping and insider trading ahead of news of an unsolicited buyout offer from News Corp.[6] As in the *Guttenberg* case, the Commission in *SEC v. Kan King Wong et al.* expressed its concerns about the fact that it was a high-ranking member of the board directly taking part in the misconduct.[7]

In May, the Commission continued its pursuit of industry professionals in *SEC v. Gansman et al.*, a case in which a former partner in Ernst & Young's Transaction Advisory Services department was charged with tipping a friend, a registered securities professional, about the identities of at least seven different acquisition targets of clients who sought valuation services from Ernst & Young.[8] The tippee in this case used the nonpublic information to trade and passed it on downstream to others who also traded on it. The Commission noted that this case underscored the importance of deal advisors and due diligence providers maintaining confidentiality and the integrity of the transactions which they help complete.

Finally, in what was one of the largest financial settlements with an individual for insider trading in the history of the SEC's enforcement program, the Commission settled *SEC v. Pai* in July. The defendant in *Pai* settled charges by agreeing to a five-year bar from serving as officer or director of a public company and payment of $30 million in disgorgement and prejudgment interest plus a $1.5 million penalty.[9] In *Pai*, the SEC alleged that between May 18, 2001, and June 7, 2001, the defendant—former Enron executive Lou L. Pai—sold 338,897 shares of Enron stock and exercised stock options that resulted in the sale of 572,818 shares to the open market. According to the SEC's complaint, Pai received material nonpublic information from Enron Energy Services successor management concerning certain financial and operational problems and substantial contract-related losses at the company. The complaint also alleged that Pai avoided substantial losses from these sales when the price of Enron stock collapsed in 2001—Enron's stock price averaged approximately $53.78 per share during the time of Pai's sales, but closed at 40-cents the day after the company filed for Chapter 11.

Hedge Funds

The past year has seen a breadth of cases against hedge fund managers for violations running the gamut from fraud and misrepresentation to improper short sales and insider trading.

Of the many cases brought by the SEC, one of the most significant of the year was *SEC v. Cioffi et al.*, one of the first enforcement actions stemming from the subprime mortgage crisis.[10] In *Cioffi*, the SEC charged two former Bear Stearns Asset Management portfolio managers—Ralph Cioffi and Matthew Tannin—for misleading investors about the health of two of the firm's largest hedge funds and their exposure to mortgage-backed securities, while at the same time selling their personal positions in the funds. According to the SEC's complaint, the defendants in the case were aware of the grave condition of the funds but failed to disclose this information to investors and institutional counterparties until the funds collapsed in June 2007, leading to losses of approximately $1.8 billion. Rather than disclosing the funds' growing troubles and allowing for an orderly wind-down of funds, the defendants in *Cioffi* allegedly made misrepresentations in hopes that the tides would shift and the funds would rebound.

The ongoing interest of criminal authorities in SEC enforcement cases was demonstrated by the parallel criminal proceedings brought by the U.S. Attorney for the Eastern District of New York against Cioffi and Tannin, charging the defendants with one count of criminal conspiracy to commit securities fraud and wire fraud, one count of insider trading, two counts of securities fraud, and five counts of wire fraud.[11] Of particular interest were the government's theories regarding the alleged criminal conspiracy and wire fraud, which were based on language in three e-mails and statements made in two phone conversations. While, according to the government, the purpose behind these statements was to entice investors to continue to support the funds while the insiders were selling, at least some of the language in question could in other contexts be categorized as aggressive salesmanship.

In addition to actions taken in *Cioffi*, the SEC continued to tread in relatively new territory created by the adoption of new rule 206(4)-8[12] which prohibits fraudulent and deceptive practices by investment advisors to various types of pooled investment vehicles. Adopted in response to the D.C. Circuit Court's decision in *Goldstein v. SEC,*[13] the rule was used in several SEC enforcements actions this past year in situations involving investment advisors who allegedly defrauded investors or prospective investors in hedge funds.

The rule, which is designed for broad application, does not require the fraud in question to be in connection with the purchase or sale of a security, nor does it have the scienter requirements of a 10b-5 action. The SEC's first case in this area came on November 26, 2007 in *SEC v. Rabinovich & Associates, LP, Alex Rabinovich et al.*[14] In *Rabinovich* , the SEC alleged that the defendants, an unregistered investment company and a broker dealer, sold limited partnership interests in an alleged fund by cold-calling investors and severely misrepresenting the performance of the fund as well as the credibility of the investment company itself. The Commission continued to use the new rule 206(4)-8 throughout the past fiscal year in similar contexts.[15]

In addition to these cases, the Commission brought cases dealing with conflicts of interests and kickbacks,[16] improper short sales,[17] market timing,[18] and late trading,[19] all of which will likely continue to be areas of interest in the coming year.

Short-selling & Rumor-Mongering

Short-selling became a major target if not regulators' *cause célèbre* in FY 2008. The SEC and other regulators seemed poised to intervene in instances where short-selling schemes were being used as vehicles for market manipulation.

During FY 2008, the Commission became increasingly concerned that intentional spreading of rumors in conjunction with aggressive short-selling was contributing to the high levels of turbulence in the market. In *SEC v. Berliner*, the SEC alleged that the defendant, a trader, intentionally spread false rumors about Blackstone Group's acquisition of Alliance Data Systems and simultaneously engaged in short-selling for a profit.

Several months after filing *Berliner,* on July 13, the SEC announced that it was going to commence examinations aimed at the prevention of the intentional spread of false information to manipulate securities prices. The examinations were to be conducted by the SEC's Office of Compliance Inspections and Examinations (OCIE), as well as the Financial Industry Regulatory Authority (FINRA) and New York Stock Exchange (NYSE) Regulation.[20] The announcement came at a time when the SEC was already expressing concern that compliance programs, while existent on paper, were lacking adequate implementation and did not satisfy regulatory requirements. The examinations would be aimed at ensuring that the appropriate prophylactic measures were in place to stave off rumor-mongering.

Almost immediately following its announcement, the SEC issued several dozen subpoenas to investment banks and hedge funds in an attempt to track down the source of a number of rumors that allegedly contributed to, among other problems in the market, the downfall of Bear Stearns and Lehman Brothers.[21] Using the broad authority to investigate under Section 21(a) of the Securities Exchange Act, the Commission began an industry-wide investigation into short-selling and rumor-mongering. In requesting e-mails, messages and phone transcripts, the SEC demonstrated a willingness to aggressively track down the sources of potentially destabilizing false statements. The added focus on rumor-mongering may have been prompted by recent developments in case law on short-selling requiring evidence of manipulative intent to violate the anti-fraud provisions.

Courts had long agreed that even fairly aggressive short-selling could constitute a legitimate trading strategy and could in fact lead to pricing efficiencies in the market.[22] As recently as last year, the Second Circuit held that short-selling is not necessarily a problematic practice.[23] In its decision in *ATSI Communications v. The Shaar Fund, Ltd.*, the court held that in order to reach levels constituting market manipulation, short-selling "must be willfully combined with something more to create a false impression of how market participants value a security."[24] Essentially, the Second Circuit's holding in *ATSI* reinforced a notion adhered to in a number of other circuits that the practice of short-selling is not inherently manipulative.[25]

While *ATSI* itself was not ground-breaking, its progeny in the Second Circuit has raised eyebrows. These cases have highlighted the tension that the recent market turmoil has created between legitimate short-selling and short-selling designed to improperly manipulate the market. For example, in *In Re Amaranth Natural Gas Commodities Litigation*, the court, effectively contradicting previous decisions[26] in the Southern District, held that the "something more" requirement in *ATSI* could be satisfied by the presence of an "improper motive."[27] Indeed, the Second Circuit's decision in *ATSI* may have cleared a path to the possibility of short-selling constituting actionable fraud even in the absence of any other manipulative conduct so long as there is an intent to manipulate securities prices.[28]

In the fall of 2008, the Commission attempted to address the spike in abusive short-selling by adopting temporary and permanent rules regarding abusive short-selling practices. The Commission's use and interpretation of these new rules against the backdrop of *ATSI* and its progeny will be of interest during the year ahead.

Enforcement & The Foreign Corrupt Practices Act

As noted by the SEC itself, another significant growth area in FY 2008 was the Commission's involvement in cases against public companies engaged in the bribing of foreign officials, a violation of the Foreign Corrupt Practices Act (FCPA).[29] Since 2006, the Commission has brought 38 FCPA enforcement actions, 15 of which came in FY 2008. This marks a continuing surge in activity in this area as the actions brought from 2006 to the present have outnumbered all those brought in previous years combined, dating back to the passing of the FCPA in 1977.

The change in the SEC's involvement in FCPA cases can be seen in kind as well as in number. Traditionally, many of the cases brought by the SEC were initiated by the self-reporting of the violators themselves. The trend that continued in FY 2008, however, was that of cases generated by leads that came from the SEC's own investigations.30 Moreover, some of these investigations have the potential for record-breaking penalties. Perhaps the most prominent example of this is the recently settled enforcement action against German industrial goliath Siemens A.G. On December 15, 2008, Siemens offered to pay a total of $1.6 billion in disgorgement and fines, the largest amount a company has ever paid to settle corruption-related charges. [31] The penalties will be paid to the SEC, the DOJ, and the Office of the Prosecutor General in Munich, Germany.

While there were a number of notable FCPA actions this year, some of the more prominent included actions stemming from the United Nations Oil for Food Program. These cases involved books and records and wire fraud charges related to kickbacks paid to the Iraqi government.

In December 2007, Dutch pharmaceutical company Akzo Nobel N.V. entered into a non-prosecution agreement with the Department of Justice and consented to an injunction with the SEC related to allegations that subsidiaries made kickbacks totaling $280,000 to the Iraqi government. Akzo Nobel agreed to pay $3 million in disgorgement, pre-judgment interest, and civil penalties in connection with its settlement with the SEC.[32]

Two months later, Texas-based Flowserve Corporation entered into a deferred prosecution agreement with the DOJ and settled books and records and internal controls charges with the SEC in connection with $600,000 in kickbacks made, and an additional $173,000 of kickbacks offered, to the Iraqi government by two of its subsidiaries. The company paid a $4 million criminal penalty and $6.55 million in civil penalties, disgorgement and interest.[33]

In March 2008, AB Volvo settled charges two of its subsidiaries allegedly paid over $6 million in illicit kickbacks to the Iraqi government. As part of its settlement with the SEC, Volvo agreed to pay $12.6 million in civil penalties, disgorgement and interest. This was in addition to the $7 million criminal penalty it agreed to pay in relation to related to wire fraud and FCPA books and records charges.[34]

The investigations into the Oil for Food program-related misconduct came as a number of industry-wide investigations were also underway, including several involving oil & gas companies and a number involving medial device companies.

The increase in the number and scope of FCPA actions in the last several years has been attributed to a number of factors, including in large part to the growing cooperation between regulators in the U.S. and their counterparts abroad. Perhaps equally significant, however, has been the increasing cooperation between the SEC and the DOJ in pursuing violations of the FCPA. In FY 2008, the DOJ took steps to address the demands of its involvement in FCPA cases by hiring several prosecutors dedicated exclusively to handle such cases.

Given the domestic and international cooperation in enforcing the FCPA and the streamlining and efficiency that has resulted, all indications are that enforcement actions dealing with international bribery will continue as an enforcement priority in FY 2009.

Other Areas to Watch

The current fiscal year will likely see further intensification of the government's efforts to rein in or at least get a conceptual grasp on practices that could exacerbate the turmoil in the market. This regulatory vigor is in some respects similar to that which followed the stock market crash of 1929 and led to the passage of the Securities Act of 1934. Both then and now, regulators realized that certain practices and tactics were simply incompatible with a stable market and, in some cases, created risks of catastrophic failure. With a new administration stepping in to oversee the financial crisis, there may be dramatic changes in store for the SEC, including a restructuring or merger with other agencies.

Nevertheless, the SEC's enforcement program is likely to have a number of focal points in FY 2009. The areas already discussed will continue to be of high interest to the Commission. There are, however, a few other key areas to watch in the coming year.

Misrepresentation of Risk and Accounting Failures

Almost certainly, there will be a renewed interest in issuer misrepresentations and accounting failures, particularly regarding the risks taken in the credit markets and mortgaged-backed securities.

In the wake of the credit crisis and mortgage meltdown, SEC enforcement is likely to refocus its efforts on the investigation of issuers and their officers and directors to determine whether they properly disclosed the risk they assumed on their balance sheets, in their investment portfolios and in their business models. The SEC may focus on failed institutions such as Lehman Brothers and their leaders to determine whether public statements accurately reflected risks, as well as on whether leaders of these institutions were improperly compensated. Having successfully charged the managers of failed hedge funds in *Cioffi*, the SEC is likely to pursue these cases aggressively.

The involvement of the U.S. Attorney's Office for the Eastern District of New York in *Cioffi* suggests that the Justice Department will continue to work with these SEC on these cases. With the new compensation disclosure rules in place, the Commission will also consider whether compensation disclosure by the issuers was adequate.

A More Assertive OCIE

SEC enforcement will also likely work more closely with OCIE on exam initiatives in the coming year. OCIE specifically stated what areas it sees as presenting the most significant risks in FY 2009.

These areas are to include:

- portfolio management;
- financial controls;
- valuation;
- sales of structured products, particularly those marketed as being low risk;
- controls and processes at recently merged or acquired firms;
- money market funds, especially with regard to exposure to undisclosed risks;
- short-selling;
- and the manipulation of securities prices through rumors and false statements.[35]

OCIE has also signaled that its future examinations are likely to be more regimented and more demanding. For example, in November, OCIE published a detailed description of the information its examiners will request in advance of onsite investigations of investment advisers.[36] In publishing its "core initial request," OCIE outlined five categories of information that targets of an examination should be prepared to present to examiners:

1. general information about business and investment activities;
2. information about any compliance programs, internal controls, and risk management;
3. documents relating to any transactional and periodic testing;

4. any actions taken to respond to violations of a compliance program; and
5. information about compliance in other areas, including but not limited to financial records.

The import of the "core initial request," however, was not necessarily in its details but rather in the fact that it offered a standardized baseline that targets of examinations would now have to be aware of and account for in their responses to the OCIE. Insofar as the OCIE considers such publications as fair warning of its expectations of its targets, there will likely be swift action by the enforcement authorities when the work of the examiners is obstructed by failure to comply with the requirements set forth in examination guidelines. This has already been demonstrated in the early months of the new fiscal year.

In November, the Commission won a decision in a case where a broker-dealer was held responsible, under a theory of *respondeat superior*, for failing to retain and produce relevant e-mails in response to an SEC investigation.[37] The information in question was maintained and destroyed by a registered representative and branch manager of the broker-dealer. However, the Commission sought to impose liability on the broker-dealer, perhaps in an effort to drive home the fact that there is no shirking of the responsibility for maintaining proper records and, perhaps more importantly, producing them to regulators in the course of investigations and examinations.

Parting Thoughts

While many of those involved in the financial crisis remain in the latter stages of hand-wringing, enforcement authorities have become increasingly forceful in their reactions over the last fiscal year. For targets of these investigations and enforcement actions this means new thresholds to meet, more demanding timelines, and smaller margins for error. For those advising them, it means reassessing the dominant thinking that has sufficed for decades and, perhaps, following the lead of the regulators in moving from a reactive to a proactive approach.

NOTES

1. SEC Press Release, "SEC Announces Fiscal 2008 Enforcement Results-Agency Brings Second-Highest Number of Actions Ever; Significant Increase in Insider Trading and Market Manipulation Cases" (Oct. 22, 2008) *available at http://www.sec.gov/news/press/2008/2008-254.htm.*
2. *See* SEC Press Release, *supra,* note 1.
3. Civil Action No. 07 CV 1774 (S.D.N.Y.) (PKC).
4. Statement Concerning *SEC v. Guttenberg* by Linda Chatman Thomsen, Director, Division of Enforcement, U.S. Securities and Exchange Commission (March 1, 2007) *available* at *http://www.sec.gov/news/speech/2007spch 030107lct.htm.*
5. SEC Press Release, "SEC Charges Two Former Accounting Firm Employees with Insider Trading" (Jan. 15, 2008) *available at http://www.sec.gov/news/press/2008/2008-6.htm.*
6. SEC Press Release, "SEC Charges Former Dow Jones Board Member, Three Other Hong Kong Residents in $24 Million Insider Trading Settlement" (Feb. 5, 2008) *available at http://www.sec.gov/news/press/2008/2008-11.htm.*
7. *See* SEC Press Release, *supra.* note 6.
8. SEC Press Release, "SEC Charges Former Ernst & Young Partner and Friend With Insider Trading" (May 29, 2008) *available at http://www.sec.gov/news/press/2008/2008-101.htm.*
9. SEC Press Release, "SEC Announces Insider Trading Charges Against Former Chairman and CEO of Enron Energy Services" (July 29, 2008) *available at http://www.sec.gov/news/press/2008/2008-151.htm.*
10. Civil Action No. 08-2457 (FB) (E.D.N.Y.).
11. *See* Indictment of Ralph Cioffi and Matthew Tannin (E.D.N.Y. June 19, 2008).
12. SEC Press Release 2007-133 (July 11, 2007).
13. *Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).
14. *SEC v. Rabinovich & Associates, LP, Alex Rabinovich et al.*, 07 Civ. 10547 (GEL) (S.D.N.Y.).
15. *See, e.g., SEC v. Jason R. Hyatt and Jay Johnson et al.*, Civil Action No. 1:08-CV-2224 (N.D. Ill. Apr. 18, 2008) (Lindberg, J.); *SEC v. Plus Money, Inc. and Matthew La Madridd, et al.,* Case No. 3:08-CV-00764-BEN-NLS (S.D. Cal. May 5, 2008).
16. *See, e.g., In Matter of Michael R. Donnell,* Admin. Proc. File No. 3-12986 (Mar. 11, 2008).
17. See, e.g., *In Matter of DKR Oasis Management Company, L.P.*, Admin Proc. File No. 3-13067 (June 12, 2008).

18. See, e.g., *In Matter of Chronos Asset Management and Mitchell L. Dong*, SEC Admin. Proc. File No. 3-12934 (Jan 25, 2008).
19. See, e.g., *In Matter of Pritchard Capital Partners LLC, et al.*, SEC Admin. Proc. File No. 3-12753 (July 10, 2008).
20. SEC Press Release, "Securities Regulators to Examine Industry Controls Against Regulation Manipulation of Securities Prices Through Intentionally Spreading False Information" (July 13, 2008) *available at http://www.sec.gov/news/press/2008/2008-140.htm.*
21. "Agency Subpoenas Focus on 4 Rumors That Hit Lehman," Wall Street Journal (July 28, 2008) available at http://online.wsj.com/article/SB121720520948988699.html?mod=googlenews_wsj.
22. *See* Brian A. Ochs, "When Does Short-Selling Become Manipulation?," *BNA's Securities Regulation and Law Report*, Vol. 40, No. 46 (Nov. 24, 2008).
23. See *ATSI Communications, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, Fed. Sec. L. Rep. (CCH) P 94363 (2d Cir. 2007).
24. *ATSI*, 493 F. 3d at 101.
25. See *Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, Fed. Sec. L. Rep. (CCH) P 98617 (7th Cir. 1995); *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, Fed. Sec. L. Rep. (CCH) P 91634 (3d Cir. 2001).
26. See, e.g., *Nanopierce Technologies, Inc. v. Southridge Capital Management*, Slip Copy, 2008 WL 1882702 (S.D.N.Y. 2008).
27. *In re Amaranth Natural Gas Commodities Litigation*, 2008 WL 4501247 (S.D. N.Y. 2008).
28. *See* Ochs, *supra.* note 21.
29. *See* SEC Press Release, *supra.* note 1.
30. See "Larger Foreign Corrupt Practices Act Fines Ahead," The National Law Journal (Nov. 25, 2008) available at http://www.law.com/jsp/law/international/LawArticleIntl.jsp?id=1202426258993.
31. SEC Press Release, Litigation Release No. 20829 (Dec. 15, 2008) available at http://www.sec.gov/litigation/litreleases/2008/lr20829.htm.
32. SEC Press Release, Litigation Release No. 20410 (Dec. 20, 2007) available at http://www.sec.gov/litigation/litreleases/2007/lr20410.htm.
33. SEC Press Release, Litigation Release No. 20461 (Feb. 21, 2008) available at http://www.sec.gov/litigation/litreleases/2008/lr20461.htm.
34. SEC Press Release, Litigation Release No. 20504 (March 20, 2008) available at http://www.sec.gov/litigation/litreleases/2008/lr20504.htm.
35. *See* Speech by SEC Staff: Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals (Oct. 21, 2008) *available at http://www.sec.gov/news/speech/2008/spch102108lar.htm.*
36. *See* Office of Compliance Inspections and Examinations Investment Adviser Examinations: Core Initial Request for Information (November 2008) *available at http://www.sec.gov/info/cco/requestlistcore1108.htm#P4_49.*
37. *In the Matter of vFinance Investments, Inc., Nicholas Thompson and Richard Campanella*, Initial Decision No. 360; File No. 3-12918 (Nov. 7, 2008) available at http://www.sec.gov/litigation/aljdec/2008/id360rgm.pdf.

Delaware Court of Chancery Decisions Highlight Importance of Paying Close Attention to Advancement Language

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Two recent decisions from the Delaware Court of Chancery have emphasized the importance of practitioners paying close attention to the language of "advancement" provisions in the governing documents of Delaware corporations and other business organizations. The cases are *Schoon v. Troy Corp.*[1] and *Sun-Times Media Group, Inc. v. Black*.[2] The *Schoon* decision was appealed, but the matter was settled prior to being heard by the Delaware Supreme Court. The *Sun-Times Media*

Group decision was not appealed. Accordingly, each decision currently constitutes persuasive—if not controlling—precedent under Delaware law.

Schoon & Advancement to a Former Director

In *Schoon*, plaintiffs included Richard W. Schoon, a current director of Troy Corp., a Delaware corporation, and Linda J. Bohnen, executrix of the estate of former Troy director William J. Bohnen. They sued Troy for advancement of defense expenses in connection with fiduciary duty claims first threatened and then filed by the company. On cross-motions for summary judgment, Vice Chancellor Stephen P. Lamb concluded that, under the governing bylaws, William Bohnen was not entitled to advancement but Schoon was.

The Court recounted that Troy had adopted several amendments to its bylaws and that those amendments "establish different advancement rights for Bohnen, as a former director, and Schoon as a current director." Quoting from the plaintiffs' brief, the Court observed, for purposes of the cross-motions, that the plaintiffs assumed "that the amendments were validly adopted."

Troy's pre-amendment bylaws had provided that "the Corporation shall pay the expenses incurred by any present or former director…." The amended provision read, "[l]osses reasonably incurred by a director or officer in defending any threatened or pending Proceeding … shall be paid by the Corporation in advance of the final disposition…." Troy told the Court that the purpose of the amendment was to "delete former directors from entitlement to advancement."

Bohnen contended that his advancement rights in the pre-amendment bylaws vested before the adoption of the amendments—at the time he took office as a director. In support of his argument, he relied upon the decision of the Delaware Superior Court in *Salaman v. National Media Corp.*[3] The *Salaman* court had stated that "the right to advancement and indemnification is a vested contract right which cannot be unilaterally terminated." But Vice Chancellor Lamb noted that the plaintiff in *Salaman* had been named as a defendant before the bylaw at issue was amended. In contrast, the Court found, Bohnen's rights under the pre-amendment bylaws had not been triggered prior to the amendments because he had not been named in certain affirmative defenses and was not a party to the lawsuit at issue.

The Court of Chancery likewise rejected Bohnen's argument that, even if the amendments to the bylaws were effective, they failed to terminate his right to advancement because of other language in the bylaws. In particular, Bohnen relied on language that read, "The rights conferred by this Article shall continue as to a person who has ceased to be a director or officer and shall inure to the benefit of such person and the heirs, executors, administrators and other comparable legal representatives of such person." The Court found that the quoted language did not aid Bohnen's cause because he had resigned before Troy initiated its fiduciary duty claims against him: "Rather, it is better understood as providing that a director, whose right to advancement is triggered while in office, does not lose that right by ceasing to serve as a director." In addition, the Court found that the bylaws as amended would still provide for *indemnification* of former directors. The Court concluded, "In short, the language of the bylaws deliberately and unambiguously provides for unequal treatment of current and former directors in receiving advancement."

The *Schoon* decision has been criticized by some commentators as sanctioning a corporation's unilateral and retroactive extinguishment of advancement and indemnification rights.[4] But it would seem that that conclusion is overbroad.

Undeniably, the *Schoon* court, on the facts presented, did find that the claimant former director was not entitled to further advancement.[5] But, doctrinally, what the Court concluded was that the right to advancement never "vested" in the first place because it had not been triggered during the time Bohnen was in office as a director. In addition, the distinction that the Court endorsed between former and current officers or directors is supported by the language of Section 145(e) of the Delaware General Corporation Law (DGCL): "Such expenses (including attorneys' fees) incurred by former directors and officers or other employees and agents may be so paid upon such terms and conditions, if any, as the corporation deems appropriate." The *Schoon* court accordingly referred to "the flexibility inherent in section 145."

What, then, is the practical takeaway from the *Schoon* decision? It would seem that, if the intention of the a corporation and an incoming director or officer is to have advancement and indemnification rights vest at the time of taking office, rather than at some later time, that can and should be explicitly stated in the governing documents—whether bylaw provisions, charter provisions, or a separate agreement. In addition, the governing document(s) can and should make clear that any indemnification or advancement protection may be increased, but not diminished (much less wholly abrogated), by amendments to bylaw or charter provisions or, for that matter, by a change in the law.[6]

Sun-Times & Appeal Advancement

Similarly emphasizing the critical importance of the language of advancement provisions in governing organizational documents is the Court of Chancery's decision in *Sun-Times Media Group, Inc. v. Black, et al.* There, plaintiff Sun-Times Media Group, Inc., formerly known as Hollinger International Inc., sought a declaration that it had no obligation to continue to advance to defendants Conrad M. Black, John A. Boultbee, Peter Y. Atkinson and Mark S. Kipnis after those individuals had been sentenced in a criminal proceeding.[7] At issue was the meaning of the words "the disposition of such action, suit or proceeding" as used in the Sun-Times' bylaws and in Section 145(e) of the DGCL. The defendants contended that the final disposition of a proceeding does not occur until the final, non-appealable conclusion to that proceeding and that, as a result, the company should be obligated to continue to advance defense expenses through the appeals of their criminal convictions and sentences.

Vice Chancellor Leo E. Strine, Jr. denied the Sun-Times' motion for partial summary judgment and sua sponte granted summary judgment to the defendants, concluding that the company was required to continue to advance expenses until the conclusion of all direct appeals.8 The Court, looking to the language of Section 145(e) and the company's bylaws, to what it viewed as the parties' course of performance under the bylaws, and to practical and policy considerations, concluded that "a final disposition is not reached until there is a final, non-appealable conclusion to a proceeding." The Court continued: "To find otherwise would be to interpret § 145(e) as creating a patchwork system of advancement that fails to provide advancement to officials for the appeal of an adverse trial court judgment. Moreover, doing so would contradict Delaware's policy of encouraging officials to resist unjustified lawsuits by discouraging them from appealing adverse trial court judgments. In turn, that might discourage qualified individuals from serving at Delaware corporations."

The Sun-Times had argued, in essence, that in order for there to be advancement entitlement in connection with an appeal, the corporation would have to have opted-in for such protection, explicitly referring to rights on appeal (as can and does occur in practice). The Court disagreed, effectively imposing a duty to opt *out* of such protection if that is the corporation's intention. Otherwise, in the absence of such an opt-out, "final disposition" will be understood to include the conclusion of all direct appeals in criminal proceedings (not applications for post-conviction relief). Presumably, the Court of Chancery would conclude likewise in connection with entitlement to advancement in defending an appeal in a civil proceeding, but that decision awaits another day.

So, what is the practical upshot of the *Sun-Times Media Group* decision, since the decision was not appealed? Until the issue is presented to the Delaware Supreme Court in another matter, practitioners would be well to heed the guidance of the Court of Chancery: "A corporation could grant mandatory advancement but circumscribe that obligation so that it explicitly excludes advancement for costs incurred in connection with any appellate stages of a proceeding."[9] Failure to heed that guidance presumably may result in a corporation learning, to its surprise, that it will have been deemed to have exercised discretion to agree to advance appellate fees and expenses to current *or* former corporate officials *no matter the outcome at trial*.

Even if advancement is not available to a former director or officer because that protection has been stripped away as in *Schoon*, the former director presumably cannot be deprived of the benefit of mandatory *indemnification*, pursuant to Section 145(c) of the DGCL, if he or she has been "successful on the merits or otherwise" at the end of the matter. And, depending upon the language of the governing documents, the former director may be entitled to permissive indemnification pursuant to Section 145(a) or Section 145(b) of the DGCL even if he or she cannot meet the standard for mandatory indemnification. Likewise, even if a corporation does choose to opt out of providing advancement in connection with appellate proceedings (or any other proceedings), the director or officer claimant still may seek indemnification of fees and expenses at the end of the matter.

Finally, for the corporation or other business organization that finds itself with governing documents that (under the *Sun-Times Media Group* holding) mandate advancement of fees and expenses in connection with an appeal, there may be some comfort in knowing that Delaware law requires *repayment* of amounts advanced if it ultimately is determined that the advancement recipient is not entitled to indemnification. Of course, the criminally convicted former corporate official may be judgment-proof by that time. Corporations wanting to guard against such a risk may seek to impose conditions on advancement such as requiring security. Whether a top-quality director or officer candidate will agree to such conditions may be another matter.

Conclusion

In sum, Delaware law provides substantial flexibility in determining whether advancement of defense expenses will be provided and, if so, under what circumstances. Real-life negotiation of advancement provisions may result in certain language being left "on the cutting room floor." But, as the *Schoon* and *Sun-Times Media Group* decisions demonstrate, careful consideration of the consequences of using—or not using—that language is imperative.

NOTES

1. *Schoon v. Troy Corp.*, 948 A.2d 1157 (Del. Ch. 2008).
2. *Sun-Times Media Group, Inc. v. Black*, 954 A.2d 380 (Del. Ch. 2008).
3. *Salaman v. National Media Corp.*, 1992 WL 808095 (Del. Super. Ct. 1992). Prior to the adoption of Section 145(k) of the Delaware General Corporation Law (8 *Del. C.* § 145(k)) in 1994, both the Delaware Superior Court and the Delaware Court of Chancery could exercise subject matter jurisdiction over indemnification and advancement disputes. Section 145(k) vests the Court of Chancery "with exclusive jurisdiction to hear and determine all actions for advancement of expenses or indemnification brought under this section or under any bylaw, agreement, vote of stockholders or disinterested directors, or otherwise."
4. The National Association of Corporate Directors (NACD), which had served as *amicus curiae* in *Schoon* while the advancement decision was on appeal before the Delaware Supreme Court, filed a motion to vacate the Court of Chancery's holding in the case after Bohnen and Troy filed a stipulation of dismissal in the appeal and the Supreme Court approved the dismissal. The NACD's motion requested that "the trial court's decision be vacated in order to eliminate its precedential effect" and suggested in the alternative that the Supreme Court "act *sua sponte* to order the opinion of the Court below vacated." The Supreme Court, by Order dated November 13, 2008, refused the motion to vacate, finding that it no longer had jurisdiction over the appeal. *Bohnen v. Troy Corp.*, 2008 Del. LEXIS 514 (Del. Nov. 13, 2008).
5. Bohnen had received from Troy advancement of certain attorneys' fees and other expenses in connection with opposing Troy's motion to amend its answer in a books and records action to assert counterclaims against Schoon, Bohnen, and others. *Schoon*, 948 A.2d at 1162-63. The Court concluded that, to the extent Bohnen had not received all of these fees and expenses, he was entitled to such. *Schoon*, 948 A.2d at 1168 n.49.
6. *See* 8 *Del. C.* § 145(f) ("The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under

any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action such person's official capacity and as to action in another capacity while holding such office.").

7. The author and his law firm served as Delaware counsel to Sun-Times Media Group, Inc. in the case.
8. The Final Judgment and Order entered by the Court on September 29, 2008 stated in part, "The Sun-Times shall continue to advance reasonable attorneys' fees and other expenses to the defendants until the final disposition of *United States v. Black, et al*., 05 CR 727 (N.D. Ill.), that is, until all direct appeals in that proceeding and any remands therefrom, together with any additional direct appeals are resolved or the time for filing any direct appeals shall have expired."
9. The Court stated, "Section 145(e) serves only to authorize corporations to provide advancement to their officials and allows corporations to contractually limit that right." In a footnote appended to that sentence, the Court quoted from other Delaware case law to the effect that Section 145(e) is "permissive, not mandatory," and that "a corporation is free to limit the terms of advancement and even preclude advancement entirely." *Sun-Times Media Group, Inc.*, 954 A.2d at 406 n.104.

Executive Compensation in a Challenging Economic Environment

BY MICHAEL J. SEGAL, JEANNEMARIE O'BRIEN, ADAM J. SHAPIRO, JEREMY L. GOLDSTEIN & DAVID E. KAHAN

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As 2008 draws to a close and companies continue to weather the worst economic climate in a generation, compensation committees and senior management will confront unprecedented challenges in 2009. This article describes key compensation issues that have emerged as a result of the financial downturn.

Stock Options Deeply Underwater

The stock market swoon has resulted in employees of many companies holding a significant number of deeply underwater stock options. Compensation committees may determine that those options have lost meaningful incentive and retentive value. Under these circumstances, a compensation committee may wish to consider making a one-time special option grant, or accelerating the 2009 option grant, in order to take advantage of depressed share prices and restore the incentive and retentive impact of company options. Similarly, tandem or independent grants of restricted stock or restricted stock units may promote retention and ensure that equity awards have some value regardless of stock price performance. Of course, any special equity grants will deplete available shares under equity plans and increase share overhang and may generate unfair criticism that employees have effectively "doubled up" on their equity compensation opportunity. As discussed below, an option exchange program may mitigate some of these concerns.

A company may conduct an exchange offer in order to replace deeply underwater options with fewer, newly granted at-the-money options, or other equity-based awards such as restricted stock units. Option exchange programs typically raise considerations under securities laws (a company must file a Schedule TO, leave an offer open for at least 20 days and describe the exchange program in the next filed annual proxy statement), accounting rules (an exchange may result in additional compensation expense) and stock exchange requirements (other than in the case of the rare equity plan which specifically permits repricing, a company must obtain shareholder approval). In general, RiskMetrics will recommend shareholder approval of an option exchange program only if (i) there is a compelling rationale for the program, (ii) the exercise price of the surrendered options exceeds the 52-week high trading price of the stock, and (iii) executive officers and directors are excluded from the program. While a program which offers to exchange options for cash does not require shareholder approval under stock exchange rules, RiskMetrics typically will recommend that shareholders withhold votes against the compensation committee members of a company that engages in a cash-for-options exchange program without shareholder approval.

Unexpectedly Large Equity Award Grants

Many companies determine the number of equity awards granted to employees by reference to a specified dollar value. If a company's stock price has declined precipitously, strict application of a formulaic award level can result in equity grants with respect to an unexpectedly large number of shares and can accelerate depletion of a plan's share reserve. Under these circumstances, the grant of "full value awards" (such as restricted stock or restricted stock units), rather than stock options, may make sense in order to maximize plan share usage.

If a company does not have adequate shares available under its plans to make new equity grants, it may make grants subject to shareholder approval; however, a contingent award may have a decreased incentive and retentive impact. A company may also grant awards outside of its existing plans in the form of cash-settled phantom equity or stock appreciation rights, although cash-settled awards will result in "mark-to-market" accounting, and awards granted outside of a shareholder approved plan will not satisfy the performance-based exception of Section 162(m) of the Internal Revenue Code.

Annual Bonus Goals Not Attained

Many companies will find that 2008 performance will result in bonus goals not being achieved. In that case, a compensation committee must decide whether to use its business judgment to override the applicable performance goal and make discretionary bonus payments in order to promote retention or to reward outstanding individual performance. With respect to named executive officers, a compensation committee must disclose the rationale for overriding an objective bonus formula in the Compensation Discussion and Analysis of the 2009 proxy statement, and may need to report on a Form 8-K bonus payments made despite non-satisfaction of performance goals. Any such discretionary bonuses will not qualify as "performance-based compensation" for purposes of Section 162(m), and the compensation committee should carefully document the rationale for such payments in order to preserve the performance-based compensation exemption under Section 162(m) for future bonuses.

Given the possibility of significant economic volatility in 2009 and the generally uncertain business climate, compensation committees may wish to consider "smoothing" the bonus formula by adopting quarterly or semi-annual goals and/or increasing reliance upon subjective measures rather than strict, pre-established performance goals. It is possible to structure a bonus program to both preserve Section 162(m) deductibility and maintain flexible objectives by adopting an "umbrella" performance goal for the entire year that establishes a maximum award that may be reduced due to the compensation committee's exercise of "negative discretion" based on application of subjective and/or short terms goals.

Problems Retaining Employees

While job opportunities may be limited in the current environment, the most critical employees are often the most likely to have alternatives. If a company determines that employees are at risk of leaving, it may be wise to develop a special retention program of cash or full-value equity awards that vest over time. Such a program will provide tangible incentives for employees to remain committed even if the company's stock price declines after grant. Companies should specify whether to include any such retention awards in the formula to determine severance and retirement benefits, and how such awards may affect regularly scheduled annual equity grants.

Takeover Fears

Once the financing markets recover, depressed stock prices may lead to increased hostile takeover activity. The mere threat of a hostile takeover can disrupt a target's employees and damage the target's business even if a raider withdraws. Appropriate change of control employment agreements and other measures can help mitigate these concerns. Ideally, companies should establish suitable arrangements in advance of a hostile bid to ensure a stable and dedicated employee base.

RiskMetrics 2009 Corporate Governance Policy Updates and Process

RiskMetrics Group is a global financial risk management firm that provides risk management, corporate governance and financial research and analysis for financial institutions and corporations worldwide. The following article is published with permission from the Executive Summary of the firm's annual Corporate Governance Policy Updates and Process, which describes the firm's core policies for the 2009 proxy season, which will be in effect for shareholder meetings on or after February 1, 2009. Contact RiskMetrics Group at www.riskmetrics.com.

Background and Introduction

Each year, RiskMetrics Group undertakes an extensive process to update the policies that inform its proxy voting recommendations. Our commitment is to make our policy formulation process open and transparent, so that all members of the financial community—including our institutional investor clients and corporate issuers—understand the foundations of our benchmark policies and proxy voting recommendations.

Our bottoms-up policy formulation process collects feedback from a diverse range of market participants through multiple channels: an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season.

Each year, the RiskMetrics Group Policy Board uses this input to develop draft policy updates on the most important governance issues, which are then published for an open review and comment period. This year, comments were posted verbatim to the RiskMetrics Policy Gateway, in order to provide additional transparency into the feedback we have received.

This document summarizes the outreach process and explains the key changes made to RiskMetrics Group's U.S., Canadian and International benchmark corporate governance policies. The full text of the updates is available through the RiskMetrics Group Policy Gateway at www.riskmetrics.com/policy.

2009 Policy Formulation Process

Throughout the year, RiskMetrics Group's governance research team identifies emerging corporate governance issues as it analyzes proxies and interacts with investor clients, shareholder proponents, and corporate issuers. In addition, the research team collects data on meeting agendas, vote results and corporate governance practices which together provide insight into how industry stakeholders are approaching these governance issues.

The Policy Board assembles these analyses in identifying specific policy topics where updates to RiskMetrics' benchmark policy should be further investigated. These topics are incorporated into questions in an annual Policy Survey, which is intended to assess the range of investor and issuer opinion on these topics.

This year's survey was fielded in July and August, 2008, after the end of the U.S. proxy season. The survey contained policy questions on Board, Compensation, Audit, Corporate Responsibility and other corporate governance topics.

Institutional investor input was solicited through five regional surveys:

- United States;
- Canada and Latin America;
- United Kingdom;
- Europe, comprising France, Germany, Ireland, Portugal, The Netherlands, Scandinavia (Sweden, Norway) and Russia;
- Asia-Pacific, comprising Australia, Hong Kong, Singapore, South Korea and Japan.

Institutional investors were also invited to participate in a general international survey which sought investor opinion on issues that apply to multiple markets as well as general principles in treating governance issues in an increasingly global investment environment.

For the first time, corporate issuers were invited in 2008 to participate in a parallel version of the United States policy survey. Invitations were sent to a broad range of issuers in the United States—contacts were drawn from standard industry databases of corporate governance and investor relations staff at U.S. corporations. The issuer survey contained close to identical versions of all questions in the institutional survey that would be applicable to corporate issuers.

Over 700 total responses were received for the surveys. On the institutional side, 317 institutional investor responses were submitted, representing a total of 200 unique institutions (approximately 12% of RiskMetrics' governance clients). On the corporate side, 390 corporate issuer responses were received.

The institutional respondent profile is close to the overall profile of RiskMetrics' governance client base, with slightly over half being investment managers or mutual fund managers, and the balance divided between pension funds and endowments, insurance companies, banks and investor groups. The corporate responses represented a broad range of issuers across the market capitalization and industry sector spectrums, as well as some corporate advisors and issuer organizations.

In addition to the policy survey, RiskMetrics solicited feedback on specific, high-profile topics from industry constituents:

- Several institutional investors and consultants participated in a telephonic roundtable on resetting performance goals and repricing of stock options on October 2, 2008.
- Compensation topics were also the subject of discussion with twenty investors and issuers in conjunction with the Council of Institutional Investors Fall meeting on October 5, 2008.
- As part of RiskMetrics' Governance Exchange program, investors, directors and corporate issuers discussed the independent

chair issue on a webcast on September 16, 2008.

- Share buybacks and discharge of directors were the subject of a governance roundtable at RiskMetrics' European client conference on September 16, 2008.

The Policy Board uses the feedback collected through the policy survey and roundtables to inform the development of draft policy updates that also incorporate findings from academic research and RiskMetrics' own analysis of corporate governance data.

Prior to being finalized, the most important policy updates are released for an open comment period, where all market participants are invited to provide input on the proposed new policies. This year, thirteen draft policies were released to the public on October 14, 2008 on the RiskMetrics Group Policy Gateway, with a broadly announcement via press release. During the three-week comment period that followed, about 20 different organizations submitted 58 separate comments on the policies. Most comments were submitted by corporate issuers and issuer groups, and were concentrated on the U.S. draft policy updates.

This feedback, including results from the Policy Survey, draft policy updates, and comments received, are all available on the RiskMetrics Group Policy Gateway at www.riskmetrics.com/policy.

Summary of Policy Updates

The highest profile updates are summarized below. The full text of the U.S., Canada and International policy updates is available through the RiskMetrics Group Policy Gateway.

United States & Canada Policy Updates

Poor Pay Practices (U.S. & Canada)

RiskMetrics recognizes the momentum towards improving executive pay practices and has revised its compensation policies accordingly. The U.S. Poor Pay Practices policy, which identifies pay practices that would prompt recommendations against compensation committee members, has been expanded to include:

- new change-in-control arrangements that include tax gross-ups on excise payments triggered by severance ("golden parachute") payments,
- tax gross-ups on executive perks,
- modified "single-trigger" change-in-control provisions that allow an executive to receive a change-in-control payment upon voluntary resignation, and
- payment of dividends or dividend equivalents on unearned performance awards.

In the RiskMetrics 2007-2008 Policy Survey, a vast majority (76%) of respondents considered excise tax gross-ups to be problematic. In addition, our analysis of estimated change-in-control payments for the S&P 500 companies, as disclosed in 2008 proxy statements, found that companies with tax gross-ups have significantly higher change-in-control payouts. Potential payouts for named executive officers at companies providing tax gross-ups averaged $72.5 million, nearly $30 million higher than for companies not providing tax gross-ups. Only $12 million of the difference is due to the amount of the gross-up, indicating that the gross-up may be prompting higher change-in-control payments.

Commenters on the draft policy update noted that tax gross-ups may have a legitimate use in equalizing payouts across similarly-situated executives who may have a different exposure to the excise tax, based on disparate pay or option exercise history. Given strong investor opinions about gross-ups and the evidence that they inflate change-in-control payouts, the Policy Board has included new agreements that include excise tax gross-up provisions, as well as all gross-ups on executive perks, in the Poor Pay Practices policy.

In order to clarify RiskMetrics' treatment of excessive perks such as personal use of corporate aircraft, security systems, and car allowances, the updated policy establishes guidelines for evaluating whether a given perk is excessive. In response to issuer comments that the fixed dollar thresholds proposed in our draft updates were inflexible, the new policy provides guidance for case-by-case analysis of the value of perks.

In Canada, where compensation-related disclosure has substantially improved and will provide shareholders with similar information as available to U.S. shareholders, RiskMetrics is introducing a Poor Pay Practices policy. The updated policy, for members of the S&P/TSX index, will recommend withhold votes for compensation committee members at companies with poor pay practices, and recommend against equity plans that are a vehicle for poor pay practices. Poor pay practices are defined along similar lines as the U.S. policy.

Shareholder Proposals and "Resetting & Repricing" Equity Plans

RiskMetrics is also aligning our policies on compensation-related shareholder proposals to the practices outlined in the U.S. Treasury's rules under the Emergency Economic Stabilization Act of 2008. Proposals on "claw-backs" of incentive pay, for example, may now receive support if existing company policy does not meet the practices outlined by Treasury. Proposals seeking holding requirements for executives receiving stock-based incentives will, similarly, be evaluated with a view to the risk-incentivizing behavior associated with certain incentives. By the same token, RiskMetrics will not view market deterioration, in and of itself, as an acceptable reason for companies to re-price stock options or reset goals under performance plans. Given the extraordinary levels of market volatility, RiskMetrics is also using 400-day stock volatility in measuring the cost of equity plans.

Compensation Peer Groups

RiskMetrics Group's proxy research reports for annual meetings of Russell 3000 companies display the pay of CEOs relative to their peers. For 2009, the methodology that we use for constructing peer groups has been changed, in response to both institutional investor and issuer feedback. Under the new methodology, company size will be a key determinant in constructing these peer groups, with peers falling between 0.5 and 2.0 times the company's size, measured by revenue, assets or market capitalization as appropriate. The minimum number of companies in the peer group has been reduced to 8, and for very large companies, peers may be drawn from a wider industry-sector or index pool, in order to create a group of reasonably similar companies.

As we look to the critical issues facing companies and investors in evaluating executive pay this coming year, we recognize the unique circumstances that companies face in assessing the market for corporate talent while providing consistent, meaningful information to our investor clients. Therefore, we plan to add to our research reports a comparison of CEO pay under both our peer group methodology and the peer group selected by the company. The updated peer group methodology, as indicated in our policy updates, will be released in 2009. The report modification that will compare RMG's peer group to the company's peer group will be released at a later date. We will continue to provide updates on the timeline for release of the report modification.

Harmonization of Performance Tests (U.S.)

Several RiskMetrics policies incorporate an evaluation of company performance: the Performance/Governance Evaluation for Directors, Pay for Performance, and the policy for evaluating Independent Chair (Separate Chair/CEO) Shareholder Proposals.

The 2009 updates harmonize the measure of performance across these policies, and introduce a relative basis for assessing performance. Under the new policies, poor performance for Russell 3000 companies is defined as below-median total shareholder returns, relative to industry peers or the index as a whole, for one- and three-year periods.

This update reflects a broadly-held belief among investors and issuers that relative performance measures are more meaningful, especially during a period of high market volatility. While some issuers commented that TSR is one of a variety of metrics that might be used to assess performance, TSR is the single most tangible indication of re-turn on investment from a shareholder perspective. In addition, the performance measure is one input into RiskMetrics' broader analysis of a company's practices and performance, not a single bright-line test.

Independent Chair Shareholder Proposals (U.S.)

As in prior years, RiskMetrics will generally recommend in favor of shareholder proposals requiring that the Chair's position be filled by an independent director, unless the company maintains a counterbalancing governance structure with an independent lead director and established governance guidelines, does not exhibit poor TSR performance, and has no problematic governance or management issues.

Updates to this policy in 2009 include a harmonization of the performance measure with other policies and a clarification of what constitutes problematic governance and management issues. The updated policy also removes a requirement to formally disclose a comparison of the duties of lead director and chair and a rationale for combining the roles.

This policy drew many comments from the issuer community. Several noted that only 38% of investor respondents to the Policy Survey supported separating the roles. In fact, 67% of investor respondents indicated that a combined role was either generally unacceptable or was acceptable with good governance provisions and a satisfactory rationale. Indeed, a majority of issuer respondents (55%) fell into these groups as well. The policy provides a framework for evaluating whether good governance provisions and a satisfactory rationale for the combined role are present.

Other commenters noted that a TSR metric for assessing performance was inappropriate, and referenced academic studies that found a negative correlation between performance and the presence of an independent chair. Our review of academic research has found that the evidence for a correlation was inconclusive. However, half of investor and nearly two thirds of issuer respondents to the Policy Survey identified strong company performance as a satisfactory rationale for maintaining a combined role, leading us to incorporate a relative performance measure into our policy.

Poor Accounting Practices (U.S.)

The updated Poor Accounting Practices policy provides additional transparency into the issues that would trigger a deeper, case-by-case analysis of accounting practices, as well as the factors that RiskMetrics would analyze in making a recommendation against either the audit committee or the full board.

Several commenters on RiskMetrics' draft policy update objected to including regulatory investigations as a potential factor for triggering greater scrutiny over accounting practices. In the Policy Survey, investors identified misapplication of GAAP and material weaknesses in Section 404 disclosures as the most likely to prompt a vote against either board or audit committee, and these issues, along with fraud, are specified as poor accounting practices that would trigger a deeper analysis.

The policy further specifies that this analysis will take into account the severity, breadth, chronology and duration of the accounting practices in question, along with the company's efforts to remediate and correct these practices.

The policy has been also been updated to recommend against audit committee members in the case of an adverse opinion from auditors on the company's financial statement. While several commenters on the draft update recommended that RiskMetrics treat this on a case-by-case basis, an adverse opinion indicates an inability of the auditor to resolve accounting issues with company management and represents a failure of board oversight.

International Policy Updates

Both share buyback and director discharge were the subject of white papers by RiskMetrics Group research analysts released this fall. These papers were, in turn, discussed by RiskMetrics Group's institutional investor clients at RiskMetrics' annual European client conference in Lausanne Switzerland, in September. This research and discussion informed the policy updates summarized below.

Share Buyback

RiskMetrics' Share Buyback policy is being updated to reflect client feedback and regulatory developments in the EU, which now allow member states a broader range of possibilities with regards to share repurchases. The updated policy establishes a maximum volume of 10% of outstanding shares (15% in the U.K.), with a cap of 10% of shares to be kept in treasury, and a maximum duration for repurchase authority of 18 months. RiskMetrics will continue to recommend against repurchase proposals that are against the interest of shareholders, e.g., can be used for takeover defenses or can be abused.

Discharge of Directors

RiskMetrics has updated its Discharge of Directors policy for European companies to reflect a transformation in shareholders' willingness to exercise their rights. The discharge resolution is a prominent, but undervalued, tool for shareholders to communicate with directors.

Under the updated policy, RiskMetrics will recommend against discharge of directors on a case-by-case basis when there is reliable information that the board is not fulfilling its fiduciary duties; for example:

- a lack of board oversight or board members operating in private or company interest rather than in shareholder interest;
- the presence of legal actions that aim to hold the board responsible for breach of trust, beyond the fiscal year in question for discharge; or
- the presence of egregious governance issues where shareholders will bring legal action against the company or its directors.

The intent of this update is to provide an additional mechanism for shareholders to express their discontent with directors—to provide a cautionary "yellow card" to directors instead of a "red card" signifying shareholders' desire for removal of directors.

Policy updates are available at www.riskmetrics.com/policy.

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