WHITE & CASE

Client Alert

Capital Markets

January 2013

Considerations for the 2013 Form 10-K and Annual Proxy Season

Colin Diamond
Partner, New York
+ 1 212 819 8754
cdiamond@whitecase.com

Holt Goddard
Partner, New York
+ 1 212 819 8685
hgoddard@whitecase.com

David Johansen
Partner, New York
+ 1 212 819 8509
djohansen@whitecase.com

Michelle Rutta
Partner, New York
+ 1 212 819 7864
mrutta@whitecase.com

The upcoming 2013 proxy season will likely be impacted by new policies issued by proxy advisers, as well as shareholder activists taking advantage of previously adopted rules, rather than by recent legislative or rulemaking initiatives. In addition, aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") continue to lurk in the background awaiting rulemaking initiatives by the US Securities and Exchange Commission (the "SEC"). Against this background, this Client Alert summarizes key issues that public companies should consider in preparing their Form 10-Ks and annual proxy statement disclosures, as well as in reviewing their corporate governance practices.

2012 Proxy Access Trends and Recent Guidance Issued Under Amended Rule 14a-8

2012 Proxy Access Trends

On August 25, 2010, the SEC adopted changes to the federal proxy rules that ultimately became effective on September 20, 2011 and enable shareholders to submit proposals for inclusion in a company's proxy statement, pursuant to Rule 14a-8 under the Securities Exchange Act of 1934 (the "Exchange Act"), that seek to amend provisions in a company's organizational documents regarding director nomination procedures (the "Private Ordering Rule").[1] The Private Ordering Rule was necessary because the SEC had adopted an amendment to Rule 14a-8(i)(8) in 2007 permitting companies to exclude from their proxy materials any proposal relating "to a nomination or an election for membership on the company's board of directors… or a procedure for such nomination or election."[2] As a result, the 2013 proxy season is the second proxy season during which shareholders may submit proposals for inclusion in a company's proxy statement seeking to amend provisions in a company's organizational documents relating to proxy access for elections in general. Furthermore, while Rule 14a-8 proposals are generally precatory (i.e., non-binding), the one exception is amendments to a company's bylaws. As a result, starting in 2012, shareholders have had the opportunity to establish proxy access standards on a company-by-company basis through the Rule 14a-8 process, whether on a precatory or binding basis.[3]

1 The Private Ordering Rule was adopted at the same time as rules requiring companies to include director nominees of eligible shareholders in company proxy materials pursuant to a new Rule 14a-11 (the "Mandatory Proxy Access Rule") under the Exchange Act. The Mandatory Proxy Access Rule was vacated by the US Court of Appeals for the District of Columbia Circuit on September 20, 2011, but the Private Ordering Rule was not litigated and therefore remained in effect.

2 See our September 2010 Client Alert, "Explanation and Practical Tips Regarding the SEC's New Proxy Access Regime," available at http://www.whitecase.com/alerts-09012010/

3 See our September 2011 Client Alert, "Proxy Access–End Game for Now," available at http://www.whitecase.com/alerts-09082011/

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

More than 20 such proxy access proposals (half of which were binding) were submitted by shareholders during the 2012 proxy season, of which nine came to a vote. A majority of the remaining proposals were determined by the SEC to be excludable for a variety of technical reasons. Of the nine that came to a vote, only two precatory shareholder proposals received over 50 percent of the votes cast. Despite the limited success of proxy access shareholder proposals in 2012, the issue of proxy access is likely to be the subject of numerous shareholder proposals in the 2013 proxy season.

Companies should prepare for this issue by engaging with significant shareholders and reviewing their policies on the implementation and early disclosure of governance enhancements and the use of the standard Rule 14a-8 bases for shareholder proposal exclusion. In addition, if a company believes that it will become subject to a shareholder proxy access proposal, it should consider whether it wishes to include in the proxy statement an alternate, more acceptable, proxy access proposal from management. This approach would enable the company to exclude the shareholder proposal pursuant to Rule 14a-8(i)(9) on the basis that it conflicts with a company proposal that is included in the proxy statement. Alternatively, the company may be able to reach an agreement with a proposing shareholder that an amended proxy access proposal will be included in the company's proxy statement in the following year as a management proposal.

Recent Rule 14a-8 Guidance

On October 16, 2012, the SEC issued Staff Legal Bulletin 14G (the "Bulletin") providing guidance on three areas:

- **Proof of ownership.** In order to submit a Rule 14a-8 proposal, a shareholder must, among other things, have continuously held shares with at least US$2,000 in market value, or representing 1 percent of the company's securities entitled to be voted on the proposal at the shareholder meeting, for at least one year as of the date the shareholder submits the proposal. The SEC had previously stated that shareholders that held their shares in street name must provide proof of the required ownership by providing a letter from a DTC participant (usually the registered broker-dealer with which they hold their brokerage account). The SEC staff clarified in the Bulletin that a letter from an affiliate of a DTC participant is sufficient proof of such ownership.
- **Notification of failure to satisfy eligibility.** If a company seeks to exclude a shareholder proposal because the shareholder failed to provide adequate proof that it has satisfied the one-year holding period, the company's notice of defect must state the specific date on which the proposal was submitted and explain that the shareholder must provide proof of ownership verifying continuous ownership through that date. The shareholder has 14 days to respond. A notice of defect that does not include such statements will not be considered effective to exclude the proposal.
- **References to website addresses.** References to website addresses are not per se prohibited, but the SEC staff previously indicated in Staff Legal Bulletin 14 that the website reference itself may be excluded if the information contained on the website is materially false or misleading, irrelevant to the subject matter of the proposal or otherwise in contravention of the proxy rules, including Rule 14a-9. The Bulletin further clarifies that (1) the proposal itself may be excluded as "vague and indefinite" if the material included in a referenced website is necessary to understand with reasonable certainty what actions or measures the proposal requires, (2) it is permitted for the referenced website not to be operational at the time the proposal is submitted provided the website's content is provided to the company and (3) a change to the content of a referenced website after submission of the proposal may constitute "good cause" for the company to submit to the SEC staff reasons to exclude the proposal after the 80-day deadline before it files its definitive proxy materials set forth under Rule 14a-8.

2013 ISS Updates

On November 16, 2012, Institutional Shareholder Services Inc. ("ISS"), the most widely followed US proxy advisory firm, issued its US Corporate Governance Policy 2013 Updates (the "2013 Updates").[4] The 2013 Updates apply to shareholder meetings held on or after February 1, 2013. The 2013 Updates focus on the following corporate governance issues:

Board Responsiveness to Governance Failures

ISS currently recommends, under extraordinary circumstances, an against or withhold vote with respect to individual directors, committee members or the entire board due to, among other things, material failures of risk oversight. The 2013 Updates clarify the definition of "failure of risk oversight" through examples provided in a footnote. These examples include, but are not limited to, bribery, large or serial fines or sanctions from regulatory bodies, significant adverse legal judgments or settlements and hedging of company stock or significant pledging of company stock by directors or executives. The key change made by ISS in the 2013 Updates is that any hedging of company stock and significant pledging of company stock by directors or executives will be viewed as a failure of risk oversight. ISS clarifies that hedging includes a "covered call, collar or other derivative transactions" on the basis that these transactions sever the ultimate alignment with shareholder interests. ISS believes pledging may negatively impact a company's stock price if the pledged company shares are forced to be sold or if the pledging of shares is used as part of hedging

4 *See* "ISS U.S. Corporate Governance Policy 2013 Updates," November 16, 2012, available at http://www.issgovernance.com/files/2013USPolicyUpdates.pdf

efforts that would potentially immunize an executive against economic exposure to the company's stock.

It is unfortunate that this new ISS position appears to be inflexible to the point that it encourages directors and executives to sell stock rather than, for example, entering into a hedging transaction that could be viewed as neutral, such as a variable prepaid forward contract. The position also fails to consider the individual situation of a director or executive that may have substantially all of his or her wealth invested in the equity of a single company and justifiably seek a degree of protection or monetization through a bona fide pledge.

In light of this update, companies should review and strengthen their current policies regarding hedging and pledging and disclose such policies in their proxy statement. Specifically, while most companies have pledging and hedging policies (frequently incorporated into the company's insider trading policy), many companies do not include disclosure regarding such policies in their proxy statements because such disclosure is only required under the current SEC rules to the extent these policies are material to an understanding of a named executive officer's compensation. ISS has noted that it will consider (1) the magnitude of the aggregated pledged shares in terms of total common shares outstanding or market value or trading volume, (2) the company's past progress, or lack thereof, in reducing the magnitude of aggregated pledged shares over time, (3) whether shares subject to stock ownership and holding requirements include pledged company shares and (4) all other relevant factors.

Increased shareholder focus on hedging, pledging and clawback policies, as well as the modified ISS guidelines, suggest that companies should review their existing policies in preparation for the upcoming proxy season and consider modifying such policies to prohibit hedging and pledging by directors and executives. Because the clawback requirements of the Dodd-Frank Act have not yet been implemented (see the section below entitled Looking Ahead), companies should either wait before adopting clawback policies pending the adoption of the SEC rules on this issue or approve a policy recognizing that further revisions may become necessary once the new rules become effective. Companies may be increasingly concerned that investors and their advisers are becoming impatient with the "wait and see" approach and opt for the second, more proactive, of these two approaches.

Board Responsiveness to Majority-Supported Shareholder Proposals

ISS currently recommends a vote against or a withhold vote with respect to individual committee members or the entire board if the board did not implement a shareholder proposal that receives support from a majority of votes outstanding in the prior year. The 2013 Updates makes this policy more stringent by applying this test starting in the 2014 proxy season based on a majority of votes *cast* in the previous year. ISS will continue to recommend a vote against or a withhold vote if the board did not implement a shareholder proposal that receives support from a majority of votes cast in the prior year and in one of the two previous years. ISS notes that a satisfactory response will generally mean full implementation of the proposal or, if a shareholder vote is required, a management proposal to implement the proposal at the next annual meeting. ISS will assess less than full implementation on a case-by-case basis, and in December 2012, ISS provided specific guidance regarding implementation of particular types of proposals.[5] This update will likely result in companies taking a more active position on preventing precatory shareholder proposals from coming to a vote through stronger shareholder communication and by implementing, or proposing to implement, changes that address the issues raised by the shareholder proposals.

Director Attendance at Board and Committee Meetings

ISS previously recommended a vote against or a withhold vote with respect to (1) the entire board of directors where the company's proxy discloses that one or more directors failed to attend at least 75 percent of board and committee meetings, but fails to disclose the names of those directors and (2) an individual director who fails to attend at least 75 percent of the board and committee meetings, with certain acceptable reasons for a director's absence. The 2013 Updates recognize the fact that Item 407(b) of Regulation S-K requires detailed attendance disclosure. The 2013 Updates therefore remove the blanket recommendation of a vote against or a withhold vote with respect to the entire board and instead focus on the distinction between a director's actual poor attendance and any insufficient or unclear attendance disclosure in the company's proxy statement. Accordingly, ISS now recommends a vote against or a withhold vote with respect to a director (1) who attends less than 75 percent of the aggregate of the board and committee meetings for the period of the director's service, with certain acceptable reasons for a director's absence and (2) where the company's proxy disclosure is unclear or insufficient to determine whether the director attended at least 75 percent of the aggregate board and committee meetings for the period of the director's service. In light of this update, companies should review their corporate governance policies regarding attendance at board and committee meetings and update their internal policies regarding board minutes and proxy disclosure of director attendance.

5 *See* "ISS 2013 U.S. Proxy Voting Policies and Procedures, Frequently Asked Questions (Excluding Compensation-Related Questions)," December 20, 2012, available at http://www.issgovernance.com/files/2013ISSFAQPoliciesandProcedures.pdf

CEO as an "Overboarded" Director

ISS currently recommends a vote against or a withhold vote with respect to a director (1) who sits on more than six public company boards or (2) who is the CEO of a public company and sits on the board of more than two public companies besides his or her own, but the negative recommendation in that case only applies to the outside boards. The 2013 Updates clarify that, starting in 2013, (1) ISS will count all subsidiaries with publicly traded stock as separate boards and (2) although the subsidiaries are now counted as separate boards, the withhold recommendation will not be extended to CEOs who sit on the boards of controlled subsidiaries (e.g., those that are more than 50 percent owned) of which he or she is also the CEO. This update will likely encourage companies whose CEO serves on more than two other public company boards to cease serving on those other boards in order to reach the policy limits or bear the burden of a recommendation that votes be withheld from the CEO serving on those other boards.

Pay-for-Performance Evaluation Methodology

The 2013 Updates modify ISS's methodology for conducting its annual pay-for-performance analysis of a company's compensation policies by (1) updating its peer group selection methodology to, among other things, include the company's own selected peers as a factor in the ISS peer group alignment analysis and (2) including, when relevant to the analysis of large cap companies, a comparison of "realizable pay" against "grant pay."

On December 4, 2012, ISS released a set of FAQs (the "2013 FAQs"), providing additional supplementary guidance regarding the new ISS peer group selection methodology created by the 2013 Updates.[6] The 2013 FAQs explain that the new ISS peer group selection methodology maintains its focus on identifying companies that are reasonably similar to the subject company in terms of industry profile, size and market capitalization by considering certain factors specified in the 2013 FAQs and selecting peer companies from a specified five-level potential peer universe (subject to certain size constraints). These are organized in order of selection priority, with first priority given to potential peer companies within the subject company's own peer group, that have chosen the subject company as a peer or have numerous connections to such potential peers. The factors specified in the 2013 FAQs include, but are not limited to, the Global Industry Classification Scheme (GICS) categories of the subject company and the companies in its disclosed self-selected peer group for benchmarking CEO compensation, with the goal of maintaining the subject company's size at or near the median of its ISS-selected peer group and selecting a peer group with the approximate GICS industry code distribution of the subject company's self-selected peer group for benchmarking CEO compensation. ISS will evaluate the size constraints of potential peers by considering the revenue or assets and market capitalization of each potential peer. The 2013 FAQs also provide guidance on the flexibility of ISS's peer group selection should the new ISS peer group selection methodology produce inappropriate peers or fail to produce an acceptable number of peers. ISS will reconstruct its peer groups based on this new selection methodology in early January 2013, effective for annual meetings that take place on or after February 1, 2013. ISS expects that company peer groups will be reconstructed during July and August 2013, after the Russell 3000 index is updated in July 2013, with such reconstructed company peer groups in place on or after September 1, 2013. Subsequent ISS peer group construction will occur from December of the current year through early January of the following year, effective for annual meetings held on or after February 1 of the following year.

ISS's use of realizable pay for large cap companies is driven by the fact that the value attributed to stock-based compensation in Summary Compensation Tables is based on the potential value of the award as of the grant date rather than the payout at the end of the relevant performance period. In contrast, the value of stock-based compensation on a realizable basis is based on equity award values for actual earned awards, or target values for ongoing awards, calculated using the stock price at the end of the specified period. Stock options or stock appreciation rights (SARs) are revalued using the remaining term and updated assumptions, as of the specified period, using a Black-Scholes option pricing model. As a result, realizable pay often provides a better basis for comparison with peers and provides a clearer basis for presenting information to shareholders in the context of say-on-pay votes. According to a 2012 *Wall Street Journal* survey, more than 220 companies presented realizable pay data in their proxy statements in the 2012 proxy season.[7] We believe that all companies should consider whether presentation of realizable pay data is helpful to their shareholders.

Voting for Golden Parachutes in an Acquisition, Merger, Consolidation or Proposed Sale

ISS currently recommends a vote on a case-by-case basis on proposals to approve a company's golden parachute arrangements. ISS currently includes in its list of problematic pay practices arrangement features that may lead to a negative

6 *See* "ISS 2013 U.S. Proxy Voting Policies and Procedures Frequently Asked Questions on Peer Group Selection Methodology," December 4, 2012, available at http://www.issgovernance.com/sites/default/files/USPeerGroupFAQ_20121204FINAL.pdf

7 *See* "Executive Pay Gets New Spin," *Wall Street Journal*, September 25, 2012.

recommendation (among other features). These include recently adopted or materially amended agreements that provide excise tax gross ups or modified single triggers (i.e., a specified window period following a change in control during which an executive may voluntarily resign and receive severance) and potentially excessive severance payments. The 2013 Updates require consideration of all existing change in control arrangements maintained with named executive officers rather than focusing only on new or extended change in control arrangements. This change will force companies to reopen for discussion legacy arrangements even if they are not being amended or extended. The 2013 Updates provide a specific definition for "excessive cash severance" as greater than three times base salary and bonus. The 2013 Updates also explain that ISS will give more weight to recent amendments that incorporate problematic pay practice features but will also now closely scrutinize existing agreements that include multiple problematic pay practice features.

General Social and Environmental Proposals

The 2013 Updates establish overarching principles for social and environmental proposals for all markets. Issues covered under this ISS policy include a wide range of topics, such as consumer and product safety, environmental and energy issues, labor standards and human rights, workplace and board diversity, and corporate political issues. ISS recognizes that a variety of factors go into each analysis, however, the overall principle guiding all vote recommendations is how the proposal may enhance or protect shareholder value in either the short or long term. ISS recommends that voting on such proposals be on a case-by-case basis, taking into account the guiding principle. Additional factors that will be considered include, but are not limited to, the following: (1) whether the issues in the proposal would be more effectively dealt with through legislation or government regulation; (2) whether the company has already responded in an appropriate and sufficient manner; (3) whether the proposal's request is unduly burdensome (scope, timeframe or cost) or overly prescriptive; and (4) the company's approach compared with any industry-standard practices for addressing the issue, in addition to other enumerated factors.

Linking Environmental and Social Matters to Compensation-Related Proposals

ISS previously generally recommended a vote against proposals to link, or report on linking, executive compensation to environmental and social criteria with a list of certain factors to consider in deciding on an exception to this general recommendation. However, the 2013 Updates modify ISS's general recommendation from a vote against such proposals to a vote on a case-by-case basis on proposals to link, or report linking, executive compensation to sustainability criteria. ISS has replaced the listing of specific environmental and social criteria with a general reference to sustainability criteria. This change is intended to provide ISS with a more flexible approach to proposals requesting sustainability metrics in corporate executive compensation plans. In addition, ISS states that the following factors will be taken into consideration for such proposals: (1) whether the company has significant and/or persistent controversies or violations regarding social and/or environmental issues; (2) whether the company has management systems and oversight mechanisms in place regarding its social and environmental performance; (3) the degree to which industry peers have incorporated similar non-financial performance criteria into their executive compensation practices; and (4) the company's current level of disclosure regarding its social and environmental performance. The ISS revised (1) above in the 2013 Updates from "significant and persistent" to "significant and/or persistent," therefore broadening the scope of this factor to include insignificant but persistent controversies or violations. ISS continues to recommend a vote against proposals calling for an analysis of the pay disparity between corporate executives and other non-executive employees, noting that the value of the information sought by such proposals is unclear.

Lobbying Proposals

ISS previously recommended a case-by-case voting approach to proposals requesting information on a company's lobbying activities, including direct lobbying as well as grassroots lobbying activities, and considered the following factors in connection with such proposals: (1) the company's current disclosure of relevant policies and oversight mechanisms; (2) recent significant controversies, fines or litigation related to the company's public policy activities and (3) the impact that the policy issues may have on the company's business operations. The 2013 Updates have revised ISS's recommendation to be a case-by-case vote on proposals requesting information on a company's "lobbying (including direct, indirect and grassroots lobbying) activities, policies or procedures," therefore broadening the scope of activities covered by ISS's recommendation. ISS also revised the factors to be considered in connection with such proposals to include clearer language and more specific terminology: (1) the company's current disclosure of relevant policies and oversight mechanisms; (2) recent significant controversies, fines or litigation regarding the company's lobbying-related activities; and (3) the impact that the policy issues may have on the company's business operations, if specific public policy issues are addressed. ISS stated that changes were made to the general policy position to clarify the scope (all types of lobbying) and focus (lobbying policies and procedures as well as lobbying activities) of the policy.

Compensation Consultant Conflicts Disclosures

New Item 407(e)(3)(iv) of Regulation S-K requires companies to disclose in their proxy statement any conflicts of interest raised by the work of compensation consultants involved in "determining or recommending" executive or director compensation. The new requirements are effective for the 2013 proxy season. To satisfy this disclosure requirement, companies will need to conduct a conflicts of interest assessment. Although the disclosures of any actual conflicts of interest will likely be rare, companies will need to evaluate as part of their director and officer questionnaire process whether any conflicts exist. Many companies are also providing a questionnaire to their proxy advisers to seek relevant information.

As 2013 proxy statement filings begin to be filed, trends are starting to emerge with respect to the conflicts disclosure. It is expected that the disclosure will be located in either the corporate governance section of the proxy statement or the Compensation Discussion and Analysis section ("CD&A"). Some companies may choose to analyze each of the six factors set forth in Exchange Act Rule 10C-1(b)(4)(i)-(vi) in supporting their conclusions while others will simply state that they have conducted an evaluation and reached a specific determination. Many companies will likely choose to include a negative confirmation to indicate the absence of any conflict of interest (similar to the disclosures seen in the compensation risk area).

Lessons Learned in 2012 That Will Continue to Impact 2013

Peer Companies

ISS peer group selection is likely to remain a contentious area despite the 2013 Updates. ISS's peer group selection methodology can lead to a very different group of peer companies than the peer group selected by the company. This should not necessarily encourage companies to use a peer group closer to the ISS peer group. Companies should continue to analyze relevant criteria and disclose the different approaches used and the reasons for selecting their peer group. In addition, companies can inform ISS of any changes to its peer group since their last disclosure, and such input will be one factor used by ISS. In the 2013 FAQs, ISS indicates that for more than 95 percent of companies, its say-on-pay analysis would not have been affected by the new peer groups based on 2012 data. Although the 2013 FAQs provide some clarity on the methodology used by ISS in peer group selection and do take into account the companies a company believes to be its peer group, on a practical basis, a company will not know which companies will comprise its ISS peer group until it receives its ISS report.

Particularly in light of the ISS-selected peer group, we believe that a company's peer group selection process and competitive positioning will continue to receive heightened scrutiny in the upcoming proxy season. Consequently, companies may want to re-visit disclosures concerning these subjects in the CD&A section of their proxy statements, such as a more extensive explanation of how it constructs its peer group, including a reference to the two principal size criteria (revenue and market capitalization) that are used to identify peers, where the company ranks in each of these areas and a logical explanation for inclusion of any companies in the peer group that are outside of this range; how the company uses peer group compensation data in making compensation decisions (e.g., benchmarking or market check); where in the range of peer group compensation levels the company seeks to set each element of its executive compensation packages; and an explanation of any instances where actual compensation varies from target levels.

Disclosures About Prior Years' Say-on-Pay

In 2012, companies were required to report on the prior year's say-on-pay vote and discuss how the vote influenced its compensation decision-making. The legal requirement can be found in Item 402(b)(1)(vii) of Regulation S-K, which requires a company to address in its CD&A how those results were considered and what happened with regard to the company's compensation policies and decisions as a result. ISS recommends that shareholders vote against a company's advisory say-on-pay proposal where the board exhibits a significant level of poor communication and responsiveness to shareholders, which is a case-by-case determination that looks at such relevant factors including (1) whether the board failed to adequately respond to the previous say-on-pay proposal that received the support of less than 70 percent of the votes cast, taking into account the company's actual response, including the company's engagement efforts with major institutional investors regarding the issues underlying the low level of support on the previous say-on-pay proposal and other specific remedial actions and other recent compensation actions taken by the company, (2) whether the issues raised by the low support of the previous say-on-pay proposal are recurring or isolated, (3) the company's ownership structure and (4) whether the support level for the previous say-on-pay proposal was less than 50 percent, which would warrant the highest degree of responsiveness. Similarly, ISS also recommends a vote against or a withhold vote with respect to the members of the compensation committee and potentially the full board of directors if the board fails to respond adequately to a previous say-on-pay proposal that received support from less than 70 percent of the votes cast. Therefore, merely achieving a majority say-on-pay vote is not enough. Companies, even those that received strong support for their proposals, will need to describe the specific

steps that have been taken to respond to shareholders' concerns and how the company reached out to key shareholders. The CD&A section of the proxy statement should therefore not only discuss the prior year's vote, but should also discuss how the results of that vote factored into the company's decision-making regarding compensation.

Proxy Statement Summary

A new trend emerged during 2011 and 2012 to include at the beginning of the proxy statement a concise summary of the key items that any shareholder should know about the upcoming annual meeting, and the various matters being submitted to a shareholder vote. Such proxy statement summaries can be elaborate and include tables and charts. Most summaries included at least the following basic information: date, time and location of the annual meeting; items on the meeting agenda; a summary of executive compensation-related disclosure (such as an abbreviated version of the Summary Compensation Table for the last completed fiscal year and/or a compensation elements table) and the deadline for submission of shareholder proposals for the next annual meeting. In light of the increased focus on investor communication, these summaries are an additional way to convey information about the annual meeting and a company's compensation practices, and we expect that more companies will include such summaries in their upcoming proxy statements.

Compensation Discussion & Analysis; Executive Summary; Highlighting Pay-for-Performance

When drafting the CD&A section of the proxy statement, companies should be mindful that with the advent of say-on-pay (among other things), this section has evolved from being not merely a disclosure document, but also a shareholder communication tool. As such, a company's CD&A should be drafted to advocate for and support the company's say-on-pay proposal rather than to serve purely as a legal disclosure exercise. In this regard, executive summary sections continue to evolve as more companies choose to rely on such summaries to highlight their key messages, including the pay-for-performance link. In a say-on-pay environment, the executive summary of a CD&A section is primarily intended to convey the correlation between a company's financial performance and its executive compensation levels. As a result, the tone of many executive summaries has shifted towards emphasizing the "pay-for-performance" relationship. While the content of such key messages will vary from company to company, an executive summary should remain concise and well-structured, using graphs and charts to enhance clarity when appropriate. This section should, at a minimum, summarize the company's performance for the most recently completed fiscal year, explain how those results translated in the compensation actions and decisions with respect to that year, disclose any new features or changes to the executive compensation program and, for companies who received shareholder support of their compensation practices of less than 70 percent, describe the company's shareholder engagement efforts and steps taken to address compensation concerns. As discussed above, a growing number of companies are choosing to include a discussion of realized and realizable pay for the named executive officers.

This is also the first year that most emerging growth companies ("EGCs") under the Jumpstart Our Business Startups (JOBS) Act will file a proxy statement for their annual meeting. A company can only be an EGC if, among other factors, it completed its IPO on or after December 8, 2011. EGCs are exempt from the requirement to hold a say-on-pay vote and from providing a CD&A section (although they must still provide a Summary Compensation Table, an Outstanding Equity Awards at Fiscal Year-End Table and a Director Compensation Table). The provision of this limited information without a CD&A section will make it significantly harder for ISS to conduct a review of the company's executive compensation practices. This may result in ISS recommending a vote against or a withhold vote with respect to the members of the compensation committee. Whether the risk of such a recommendation matters will depend on (1) a company's share ownership structure, (2) whether it has a classified board, (3) whether the company has adopted majority voting and (4) reputational concerns. Each of these considerations could result in an EGC deciding that the voluntary inclusion of some or all components of the C&DA and/or holding a say-on-pay vote is beneficial. To date, EGCs have not adopted this approach.

NYSE and Nasdaq Proposed Rules Relating to Compensation Committees and Advisers

As reported in our June 2012 Client Alert,[8] the SEC published final rules requiring securities exchanges to change their listing standards with respect to compensation committee independence and authority, and requiring additional proxy statement disclosures regarding compensation consultants.

On September 25 and 26, 2012, the New York Stock Exchange LLC ("NYSE") and the Nasdaq Stock Market LLC ("Nasdaq") proposed amendments to their listing standards to comply with the requirements of Section 10C of the Exchange Act as set forth in Exchange Act Rule 10C-1 ("Rule 10C-1"), as mandated by

8 See our June 2012 Client Alert, "SEC Issues Compensation Committee and Compensation Consultant Independence Rules as Required by the Dodd-Frank Act," available at http://www.whitecase.com/alerts-06272012/

Section 952 of the Dodd-Frank Act relating to the independence of compensation committees and compensation advisers. The following is a summary of the new requirements under the proposed rules:

Effective Dates

Neither the NYSE nor Nasdaq proposed rules will be effective for the 2013 proxy season. The SEC's rules require the stock exchanges to adopt final listing standards no later than June 27, 2013, but do not mandate when the listing standards must take effect. The SEC is expected to approve these proposed rule changes by January 13, 2013, subject to possible extension.

Upon SEC approval, the NYSE and Nasdaq proposed rules will become effective on July 1, 2013. Both NYSE- and Nasdaq-listed companies will have until the earlier of their first annual meeting after January 15, 2014 or October 31, 2014, to comply with the new listing standards in connection with compensation committee member independence.

Compensation Committees and Director Independence

- **NYSE.** Existing NYSE rules require listed companies to have a distinct compensation committee composed solely of directors who satisfy the NYSE's general independence requirements. To comply with the requirements of Rule 10C-1, the NYSE has proposed adding new Section 303A.02(a)(ii) to its rules requiring the board of directors of a listed company to affirmatively determine the independence of any member of the compensation committee by considering "all factors specifically relevant to determining whether a director has a relationship with the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member." At a minimum, the board must consider the same factors set forth in Rule 10C-1, which include: (1) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the listed company to such director and (2) whether such director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

  In contrast to Nasdaq's proposed rules, the NYSE's proposed rules do not extend to compensation committee members a blanket prohibition on any compensation other than director's fees (subject to minor exceptions) that applies to audit committee members under Exchange Act Rule 10A-3(b)(1). The rationale behind the broader approach adopted by the NYSE is to require listed companies to view the totality of the circumstances and make a determination based on all potentially relevant factors involved. Nevertheless, it should be noted that ISS recommends a vote against any compensation committee member who is an "inside director" or an "affiliated outside director" as defined by ISS. ISS's definition of an affiliated outside director contains a five-year look-back with respect to certain prohibited relationships and a US$10,000 threshold for prohibited compensatory payments. As a result, companies that comply with ISS guidelines have already subjected themselves to more stringent independence standards.

- **Nasdaq.** Nasdaq has proposed replacing its Listing Rule 5605(d) in its entirety to comply with the requirements of Rule 10C-1. The proposed Nasdaq rule requires listed companies to maintain a compensation committee with a formal written charter that consists of at least two independent directors. This rule eliminates the exception that permits listed companies to merely have a majority of independent directors approving executive officer compensation decisions (although the proposed rule does retain the existing exception enabling a listed company to have a non-independent director serve on the compensation committee in exceptional and limited circumstances).

  In addition to meeting Nasdaq's general requirements for director independence, Nasdaq's proposed rules for compensation committee members mirror one aspect of the requirements for audit committee membership insofar as they would prohibit members of the compensation committee from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or any subsidiary, other than fees received as a member of the board or a board committee, or fixed amounts under a retirement plan for prior service with the listed company. The proposed rules also require boards to consider whether a director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company, to determine whether such affiliation would impair the director's judgment as a member of the compensation committee. No look-back would be required with respect to affiliate relationships that preceded a director's service on the compensation committee.

Compensation Committee Advisers and Adviser Independence

Both the NYSE and Nasdaq proposed rules require that pursuant to Rule 10C-1, compensation committees have the authority to retain compensation consultants, independent legal advisers and other compensation advisers, authority to fund such advisers and responsibility to consider independence factors before selecting such advisers, other than in-house counsel.

The NYSE's current listing standards require the compensation committee to have a written charter setting forth such specified responsibilities of the committee. The NYSE is adopting the Rule 10C-1 requirements verbatim and would amend the language to require that the compensation committee's charter expressly address the rights and responsibilities of the compensation committee that are required under the SEC rules.

As Nasdaq does not currently have a formal compensation committee requirement in its listing standards, these standards will be incorporated into the formal written compensation committee charter requirements.

Both sets of proposed rules declined to expand on the six independence factors set forth in Rule 10C-1 that compensation committees must consider before selecting an adviser.[9] It is noteworthy that the compensation committee is not required to follow the advice of any of its advisers, and the proposed rules do not purport to suggest otherwise. Moreover, while the compensation committee is required to consider these factors, the Dodd-Frank Act does not require that compensation advisers be independent, only that independence is taken into account when selecting an adviser. The six factors are not exclusive but rather guidelines to be used in determining independence.

Opportunity to Cure

As set forth in Rule 10C-1, both sets of proposed rules provide that if a compensation committee member ceases to meet the new definition of compensation committee independence for reasons outside the member's reasonable control, the member would be permitted to remain a member of the compensation committee until the earlier of (1) the next annual meeting or (2) one year from the date when the member ceased to be independent. Nasdaq also would provide that companies have a minimum of 180 days to cure noncompliance. Unlike the proposed Nasdaq rule, the proposed NYSE rule would limit the cure provision to situations in which a majority of the compensation committee remains independent.

Exemptions

Further to the exemptions listed in Rule 10C-1, both the NYSE and Nasdaq proposed rules would exempt smaller reporting companies, foreign private issuers and controlled companies from the heightened independence requirements for compensation committee members.

Conflict Minerals and Resource Extraction Disclosure

Form 10-Ks filed in 2013 for calendar year 2012 will not have to include "conflict minerals" or resource extraction payments disclosure, but companies will need to start tracking this information in 2013. The SEC will require disclosure of supply chain and sourcing information on several minerals and metals, termed "conflict minerals," contained in products that companies manufacture or contract to manufacture in each calendar year, beginning on January 1, 2013. All companies will have to disclose the information about 2013 in a Form SD filed no later than May 31, 2014, regardless of their particular fiscal year-end. Resource extraction companies will have to disclose information relating to their payments made to a foreign government or the US Federal Government on or after October 1, 2013 for the purpose of the commercial development of oil, natural gas or minerals. Reporting will be required for fiscal years ending after September 30, 2013; however for the first report, companies will be able to provide a partial year report covering the period from October 1, 2013 to the company's fiscal year-end. For calendar year companies, the information period from October 1, 2013 through December 31, 2013 will have to be disclosed in a Form SD by May 30, 2014. Both of these new SEC rules apply broadly and include domestic companies and foreign private issuers (including smaller reporting companies).[10]

Conflict Minerals Disclosure

Conflict minerals are defined as any and all cassiterite, columbite-tantalite (coltan), gold, wolframite, and their derivatives, including tin, tantalum and tungsten, and any other minerals or their derivatives that the US Secretary of State may determine to be financing conflicts in the Democratic Republic of the Congo and adjoining countries ("Covered Countries"). Despite the pejorative implications of such a label, the new rules do not limit the term "conflict minerals" to those minerals and metals that originated in a Covered Country. Instead, the new disclosure rules apply if any of the aforementioned four minerals or their three derivatives (regardless of origin) are necessary to the functionality or production of the product manufactured or contracted to be manufactured by the company. Without exaggeration, the breadth of this definition enables the rules to apply to almost any company that manufactures or contracts to manufacture a product with an on-off switch, affecting an estimated 6,000 companies out of approximately 14,600 total companies. Exempted from this wide-ranging application are miners of conflict minerals, unless they engage

9 See *Id.* at 4.

10 For a detailed discussion of the disclosure requirements of conflict mineral use and government payments by resource extraction companies, see our September 2012 Client Alert, "SEC Adopts Conflict Minerals and Resource Extraction Payments Rules," available at http://www.whitecase.com/alerts-09202012/

in manufacturing in addition to mining, and retailers of products containing conflict minerals, unless they exert a defined level of control over the manufacturing process of such products. Companies that believe they have no connection with conflict minerals may well find that the new rules apply to them.

The following is a summary of the three-step compliance process set forth by the final rules:

Step One—Companies Subject to the Conflict Minerals Provision

A company must first determine whether it is subject to the rules based on its use of conflict minerals. A company is subject to the rules if conflict minerals are necessary to the functionality or production of a product manufactured by the company or contracted by the company to be manufactured. As a threshold matter, conflict minerals can only be deemed necessary to a company's products if the products contain conflict minerals. However, the final rules do not contain a de minimis exception for limited use of conflict minerals, and companies may be subject to conflict minerals disclosure obligations for any amount of conflict minerals in its products. There is considerable ambiguity in the meaning of the terms "manufacture" and "contract to manufacture" owing largely to the SEC's decision to provide limited guidance on the meanings of the terms rather than define them in the rules. With respect to manufacturing, the SEC does not specify any more than that manufacturing includes assembling manufactured components into a subsequent product as well as making products from raw materials. With respect to whether a company will be deemed to have contracted to manufacture, the SEC states that such determination depends on the degree of influence it exercises over the manufacturing process, but in any case, a company will not be deemed to have contracted to manufacture if it does no more than (1) specify contractual terms "not directly related" to the manufacture of the product, (2) affix its brand to a generic product manufactured by a third party or (3) service, maintain or repair a product manufactured by a third party.

If a company determines that conflict minerals are necessary to the production or functionality of products it manufactures or contracts to manufacture, then the company is subject to the disclosure rules and must proceed to Step Two of the conflict minerals compliance process.

Step Two—Whether Conflict Minerals Originated in a Covered Country

Step Two of the conflict minerals compliance process requires the company to determine whether its conflict minerals originated in a Covered Country by conducting a preliminary review of its conflict mineral supply chain, known as a reasonable country of origin inquiry ("RCOI"). Based on its RCOI, if a company determines that either (1) its conflict minerals did not originate in a Covered Country or has no reason to believe its conflict minerals originated there or (2) its conflict minerals came from recycled or scrap sources or it reasonably believes its conflict minerals came from recycled or scrap sources, then the company is not obligated to investigate its conflict mineral supply chain further and is only required to file a Form SD. In the Form SD, such a company is required to provide a brief description of the RCOI it undertook, the results of the inquiry and a link to its website where such disclosures are publicly available. On the other hand, if, based on its RCOI, the company (1) knows or has reason to believe that its conflict minerals originated in a Covered Country and (2) does not know or does not reasonably believe that its conflict minerals come from recycled or scrap sources, the company is required to proceed to Step Three of the conflict minerals compliance process and will be required to make certain disclosures with respect to its use of conflict minerals, including the filing of a Form SD.

The SEC's rules contain an initial two-year transition period (four years for smaller reporting companies) that imposes less stringent disclosure obligations on companies with respect to conflict minerals disclosures. During this period, companies should undertake appropriate due diligence on their supply chain with a view to ensuring that they do not need to go beyond Step Two of the three-step compliance process once the rules become fully effective. Step Three requires relatively extensive and adverse disclosures if the company either knows that its conflict minerals originated in a Covered Country and are not from recycled or scrap sources, or has reason to believe that its conflict minerals may have originated in such specific countries and may not be from recycled or scrap sources.

Step Three—Supply Chain Due Diligence

In Step Three of the conflict minerals compliance process, a company undertakes due diligence of the source and chain of custody of its conflict minerals in order to more clearly determine whether the conflict minerals originated in a Covered Country and, if so, whether the conflict minerals directly or indirectly financed or benefited armed groups in a Covered Country. Additionally, the company might be required to conduct due diligence to determine whether such conflict minerals are from recycled or scrap sources. The extent of the company's conflict minerals disclosure will vary depending on the company's findings during this third step and are beyond the scope of this Client Alert.

Exemption for Existing Stockpiles

In an effort to prevent the waste or devaluation of existing stockpiles of conflict minerals that will no longer finance or benefit armed groups in the Covered Countries, the final rules exclude from consideration any conflict minerals that are "outside of the supply chain" prior to January 31, 2013. Outside of the supply

chain refers to any conflict minerals that have been smelted or fully refined and any conflict minerals that, while not smelted or fully refined, are located outside a Covered Country. As a result, a company is not required to make any conflict mineral disclosures if its use of conflict minerals is limited to those minerals outside the supply chain prior to January 31, 2013.

Resource Extraction Disclosure

Resource extraction companies will be required to disclose information relating to any payment made by the company, a subsidiary of the company or an entity under the control of the company, to a foreign government or the US Federal Government for the purpose of the commercial development of oil, natural gas or minerals. Information must be provided about (1) the type and total amount of such payments, (2) the currency in which each payment was made, (3) the financial period in which each payment was made, (4) each business segment making such payments, (5) each government receiving such payments and (6) the project to which each payment relates. Disclosure of payment information must be made under cover of Form SD, which must be filed with the SEC no later than 150 days after the end of the company's most recent fiscal year. Reporting will be required for fiscal years ending after September 30, 2013; however for the first report, companies will be able to provide a partial year report covering the period from October 1, 2013 to the company's fiscal year-end.

The new rules governing government payments by resource extraction companies will have broad applicability. The rules apply to all domestic and foreign private issuers that file annual reports with the SEC and engage in the commercial development of oil, natural gas or minerals. The term "commercial development of oil, natural gas or minerals" is not confined to upstream activities and encompasses "exploration, extraction, processing, export and other significant actions relating to oil, natural gas or minerals or the acquisition of a license for any such activity."[11] Furthermore, the rules apply regardless of a company's size, the extent of its business operations constituting commercial development of oil, natural gas or minerals or the company's status as a government-owned entity. Moreover, there is no exemption for companies that are (1) subject to similar reporting requirements under home-country laws, listing rules or an Extractive Industries Transparency Initiative program; (2) prohibited by foreign law from making such disclosures; or (3) obligated not to make such disclosures by confidentiality provisions in contracts or by reason of confidential treatment of commercially sensitive information. Companies involved in the resource extraction industry should evaluate whether these new rules will require disclosures to be made with respect to their commercial development of oil, natural gas or minerals.

Iran Sanctions Disclosure

In August 2012, the Iran Threat Reduction and Syria Human Rights Act of 2012 (the "Threat Reduction Act") was enacted, which, among other measures, created new disclosure requirements under the Exchange Act.[12] Companies must disclose publicly in their annual or quarterly reports whether they or their affiliates have knowingly engaged in sanctionable activity during the period covered by those reports.[13] This requirement is effective for quarterly and annual reports filed on or after February 6, 2013 (e.g., for calendar year reporting companies, it will first apply to their Form 10-K for the year ended December 31, 2012).

In particular, the Threat Reduction Act amends the Exchange Act to require disclosure of any knowing engagement in activities relating to Iran's energy sector described in Iran Sanctions Act of 1996, as amended by the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 ("CISADA"), or activities relating to foreign financial institutions that facilitate Iran's development of weapons of mass destruction, terrorism, money laundering or Islamic Revolutionary Guards Corps activity, as described in the CISADA. Companies must also disclose any knowing engagement in activities involving persons whose property is blocked or who are part of the Government of Iran, as well as relating to transfers of weapons and other technologies to Iran likely to be used to facilitate human rights abuses. While companies that have been specifically authorized by a foreign governmental authority to engage in activities with Iran must still disclose such transactions or dealings, the disclosure is not required if the company was specifically authorized by a US federal department or agency. This includes both general and specific licenses issued by the Office of Foreign Assets Control (OFAC) of the US Department of the Treasury. In each case, the required disclosure must be detailed as to the activity, including its nature and extent, the gross revenues and net profits attributable to such activity and whether the company or its affiliate intends to continue the activity. Companies will not be required to disclose the fact that they have not engaged in the activities specified by the Threat Reduction Act in their periodic reports.

11 *See* Item 2.01(c)(1) of Form SD.

12 For a detailed discussion of the Threat Reduction Act, see our August 2012 Client Alert, "US Strengthens Iran Sanctions Regime with Enactment of Iran Threat Reduction and Syria Human Rights Act of 2012," available at http://www.whitecase.com/alerts-08172012-4/

13 The meaning of "affiliate" as used under the new disclosure requirements is the same as under Exchange Act Rule 12b-2, which means a person that controls, or is controlled by, or is under common control with, another person.

The potential impact on companies of these new disclosure requirements should not be underestimated. Currently, the SEC is sending comment letters to companies that have disclosed activities with certain countries subject to US sanctions or that the SEC perceives may have engaged in such activities by virtue of other disclosures made by the company. Such comment letters originate from the Office of Global Security Risk within the SEC's Division of Corporation Finance. As a result, if a company has made an initial, voluntary self-disclosure to a US sanctions enforcement agency, it may delay public disclosure of the matter on the basis that it is not material to its security holders, even if the company deemed such voluntary self-disclosure necessary. The new law will result in all such activity—irrespective of materiality—being required to be disclosed in the annual or quarterly report for the relevant period. Such disclosures will need to be accurate and complete in all respects and will likely drive a more extensive range of SEC comments that will require companies to invest significant resources to respond appropriately and may also directly impact the disclosures that companies make to US sanctions enforcement agencies. In sum, the requirement of public disclosure is a significant additional tool for regulators.

Looking Ahead

The corporate governance and executive compensation disclosure requirements set forth below and mandated under the Dodd-Frank Act have not yet been implemented through SEC rulemaking and consequently will not be effective for the 2013 proxy season. None of these requirements have a specified deadline for rulemaking initiatives, but may well be the subject of rulemaking in 2013:

- **Pay-for-performance/internal pay equity.** Section 953(a) of the Dodd-Frank Act requires the SEC to adopt rules requiring companies to include in their annual proxy statement a clear description of any executive compensation, including information that shows the relationship between executive compensation paid and the financial performance of the company, taking into account any change in the value of the shares of stock and dividends of the company and any distributions ("pay for performance"). This disclosure may be presented graphically or in narrative form. Section 953(b) of the Dodd-Frank Act requires the SEC to amend Item 402 of Regulation S-K to require a company to disclose (1) the median of the annual total compensation of all employees of the issuer, except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio between the CEO's total compensation and the median total compensation for all other company employees ("internal pay equity").
- **Clawback policies.** Section 954 of the Dodd-Frank Act requires the SEC to adopt rules directing each national securities exchange to amend listing standards to require that companies adopt a policy providing that, if a company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, it will recover from any current or former executive officer who received incentive-based compensation during the three-year period preceding the date on which the company is required to prepare an accounting restatement, amounts based on the erroneous data, in excess of what would have been paid under the restatement. Additional disclosure will be required on a company's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws.
- **Director and employee hedging.** Section 955 of the Dodd-Frank Act requires the SEC to issue rules requiring companies to disclose in their annual proxy statement whether their employees or directors (or their designees) may purchase financial instruments, such as prepaid variable forward contracts, equity swaps, collars and exchange funds, designed to hedge equity securities of the company that the employee or director holds.
- **"Excessive" compensation at financial institutions.** SEC rules proposed on March 2, 2011 would require the disclosure of incentive-based compensation arrangements and prohibit "excessive" compensation at financial institutions with assets of, or exceeding, US$1 billion. The comment period for these proposed rules expired on May 31, 2011, and no further action has occurred since that date.

Note that the anticipated timing for the SEC's rulemaking schedule has been postponed by the SEC several times, and the SEC has subsequently stopped providing any estimated schedule.

This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Client Alert should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, companies and entities.
NY0113/CM/A/08404_7