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Legal Update
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Preparing for the 2011 Proxy and Annual Report Season

With the end of 2010 approaching, it is time to prepare for the 2011 proxy and annual report season. There are quite a few new developments to take into account when drafting proxy statements and annual reports, due to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) as well as and rulemakings and guidance issued by the Securities and Exchange Commission (SEC). Key issues for the upcoming proxy and annual report season are summarized below.

Say-on-Pay

All public companies that will be holding annual meetings on or after January 21, 2011 must include a non-binding say-on-pay proposal in their upcoming proxy statements. Thereafter, non-binding say-on-pay proposals must be included in proxy statements at least once every three years.

In October 2010, the SEC issued Release Nos. 33-9153; 34-63124, titled "Shareholder Approval of Executive Compensation and Golden Parachute Compensation,"[1] proposing say-on-pay rules, as well as rules for frequency votes relating to say-on-pay and golden parachute advisory votes and disclosure. The SEC is expected to issue final rules this winter, perhaps as early as January, but the effective date of the say-on-pay requirement is mandated by the Dodd-Frank Act, whether or not the SEC has adopted say-on-pay rules by then. For more information on the SEC's say-on-pay proposal and on the associated frequency vote discussed below, see our Legal Update dated October 28, 2010, titled "U.S. Securities and Exchange Commission Proposes Say-On-Pay and Vote Reporting Rules."[2]

Because the say-on-pay requirement involves new proxy statement language, it would be prudent to begin the drafting process well in advance of filing deadlines. Proxy statements for companies that received financial assistance under the Troubled Asset Relief Program (TARP), and companies that voluntarily have included advisory votes on executive compensation (sometimes in response to votes on shareholder proposals requesting such a say-on-pay), may offer a helpful starting place, although it is necessary to be sure the mandatory say-on-pay proposal complies with the SEC's rules for say-on-pay. (To the extent a company files its proxy statement before the SEC's rules are final, the proposed rules should be used as a guide.)

Companies should carefully develop the rationale they will provide shareholders to encourage votes in support of their executive compensation policies. Because of the sensitivity of this issue, companies should allow time for this section to be reviewed and revised by management, the compensation committee and the full board of directors. In addition, the entire proxy statement and proxy card should be examined to determine what revisions are necessary to reflect the say-on-pay proposal.

Although the say-on-pay vote is advisory only, public companies may want to take steps to increase the chances of shareholders approving

say-on-pay votes. Through communications with shareholders, investor relations departments can assist in the endeavor to pinpoint the focus of any sizeable investor discontent with respect to executive compensation. In addition, compensation committees may want to seek the input of their compensation consultants to determine if there are any adjustments to compensation programs that would be consistent with their objectives and policies and which could reduce the possibility that shareholders would vote to disapprove executive compensation.

Inclusion of the say-on-pay proposal makes it especially important that the compensation discussion and analysis (CD&A) clearly and effectively explains the executive compensation program and its rationale. CD&A has the potential to be more than just a response to a particular disclosure requirement of Regulation S-K, it can also supplement the company's statement in support of the say-on-pay proposal. Therefore, companies should consider whether they can improve the content and/or style of their CD&A so that it more strongly expresses their executive compensation objectives and how each compensation element is designed to motivate and reward employees. An executive summary highlighting the relationship between pay and performance and emphasizing use of good pay practices may be especially useful to the effort of eliciting a favorable say-on-pay vote.

CD&A will need to discuss how compensation decisions were impacted by the results of the say-on-pay advisory votes required by either Rule 14a-21 or Rule 14a-20 under the Securities Exchange Act of 1934 (Exchange Act). Public companies that received assistance under TARP will need to prepare that disclosure for their upcoming CD&A sections. Other public companies should consider whether to voluntarily address this question in advance of this year's advisory vote by discussing, if known, how they intend to consider the proposed say-on-pay vote in compensation decisions.

On a related note, the Dodd-Frank Act also requires an advisory vote on, and additional disclosure with respect to, golden parachutes when shareholders are voting on a change in control transaction. Because a golden parachute advisory vote is not needed at the time of a transaction if such compensation was subject to a prior say-on-pay advisory vote, some companies may want to expand their potential termination compensation disclosure in their annual proxy statements so that it complies with the new golden parachute disclosure requirements set forth in proposed Item 402(t) of Regulation S-K. However, companies considering including the new golden parachute disclosure in their annual proxy statements should note that if changes are made to golden parachute arrangements that were submitted for shareholder approval prior to a transaction, those changes will be highlighted by the inclusion of a separate table in the proxy statement for the subsequent transaction and will be subject to a golden parachute advisory vote, even though the original arrangements had previously been included in an executive compensation say-on-pay vote. The golden parachute advisory vote will not become a requirement until after the SEC adopts implementing rules.

Say-When-On-Pay

The Dodd-Frank Act also requires public companies that will be holding annual meetings on or after January 21, 2011 to include in their proxy statements a non-binding proposal asking shareholders if the say-on-pay proposal should be submitted to shareholders every one, two or three years. The proxy card must provide four choices for this frequency vote: one year, two years, three years and abstain.

Companies should determine what say-on-pay voting frequency, if any, they will recommend to shareholders and how they will describe their position to shareholders. Companies should draft the frequency proposal language for review within their organization, determine where else

in the proxy statement reference to the frequency vote is needed and prepare the appropriate proxy card language.

Companies should check whether their voting tabulators can process four choices for the frequency vote proposal on the proxy card, as contemplated by the SEC. If this proxy card format cannot be accommodated, companies should implement a policy so that undirected proxy cards are not voted on any of the frequency proposal options.

The quarterly report on Form 10-Q for the quarter in which the frequency vote occurs (or the annual report on Form 10-K, where the vote occurs during the fourth quarter) will need to disclose whether and how the results of the frequency vote for say-on-pay will be implemented. Therefore, companies should add a disclosure control to their existing procedures to ensure that this upcoming disclosure requirement is addressed.

Companies should consider adopting a policy on the frequency of say-on-pay votes that is consistent with the plurality of votes cast in the most recent shareholder vote on frequency in order to be able to exclude from future proxy statements say-on-pay or say-on-pay frequency shareholder proposals submitted pursuant to Rule 14a-8 under the Exchange Act.

SEC Interpretive Guidance

Short-Term Indebtedness Guidance. In September 2010, the SEC issued Release Nos. 33-9144; 34-62934, titled "Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis,"[3] providing interpretive guidance on the presentation of the liquidity, leverage ratios and contractual obligations disclosures in management's discussion and analysis of financial condition and results of operations (MD&A). For example, the SEC identified difficulties accessing the debt markets, reliance on commercial paper or other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral, and counterparty risk as examples of important trends or uncertainties impacting liquidity which could require disclosure in the MD&A. The SEC also stated that it may be necessary to describe variations in borrowings within the reporting period if borrowings during the reporting period are materially different than the period-end amounts. This interpretive guidance is effective and should be considered when drafting the MD&A for annual reports. For a more detailed discussed of that guidance, see our Legal Update dated September 22, 2010, titled "US Securities and Exchange Commission Issues MD&A Interpretive Guidance."[4]

At the same time that the SEC issued its interpretive MD&A guidance on liquidity and capital resources disclosures, it proposed new short-term indebtedness disclosure rules, with the comment period closing at the end of November. See Release Nos. 33-9143; 34-62932, titled "Short-Term Borrowings Disclosure."[5] The final rules may not be available in time for the upcoming annual reports for calendar year companies. However, all SEC commissioners agreed that additional short-term indebtedness disclosure rules are necessary, approving the short-term borrowings disclosure proposal unanimously. Therefore, it seems likely that new short-term borrowings disclosure requirements will be adopted in the relatively near future, making this an area that public companies will want to monitor closely. For more information on the proposed short-term indebtedness disclosure rules, see our Legal Update dated October 1, 2010, titled "US Securities and Exchange Commission Proposes New Short-Term Borrowings Disclosure."[6]

Climate Change Guidance. In February 2010, the SEC issued Release Nos. 33-9106; 34-61469, titled "Commission Guidance Regarding

Disclosure Related to Climate Change."[7] As relatively recent guidance, it is worthwhile for companies to review whether they need to include any additional, supplemented or modified climate change disclosure in this year's annual report. For more information on this topic, see our Legal Update dated February 4, 2010, titled "U. S. Securities and Exchange Commission Provides Guidance on Climate Change Disclosure."[8]

Foreclosure Issues. In October 2010, the SEC's Division of Corporation Finance sent letters to certain public companies regarding disclosure obligations in light of potential risks and costs associated with mortgage and foreclosure-related activities or exposures. An illustrative copy of the letter is posted on the SEC's website.[9] Even companies that did not receive such a letter should consider disclosures of the type described in that letter if mortgages and foreclosure activities are important to their businesses.

XBRL. In November 2010, the staff of the SEC's Division of Risk, Strategy and Financial Innovation issued a report titled, "Staff Observations From Review of Interactive Data Financial Statements."[10] In this report, the staff identified common issues in filings with eXtensible Business Reporting Language (XBRL) exhibits and encouraged companies to review their future XBRL filings to ensure they are prepared consistently the staff's observations. This report also reminded companies of the existence of frequently asked questions on XBRL.[11] Companies that already are required to prepare an XBRL exhibit for their upcoming annual reports should endeavor to reflect the staff's concerns when they tag their interactive financial statement data. Companies that will be required to first provide interactive data exhibit for the fiscal periods ending on or after June 15, 2011 should also take heed of the staff's observations in this area. For more information on the interactive financial data requirements, see our Securities Update dated February 24, 2009, titled "SEC Adopts Mandatory Use of Interactive Data for Financial Reporting."[12]

SEC Comments on Last Year's New Disclosures

A number of new disclosures were required for the first time in last year's proxy statements. For a discussion of those requirements, see our Legal Update dated January 5, 2010, titled "US Securities and Exchange Commission Adopts Executive Compensation and Other Disclosure Changes."[13] Publicly available SEC comments to individual companies on disclosure requirements that were new in 2010 provide insight on how some of these disclosures can be improved for the second season. Some key comments are highlighted below.

Compensation Risk. Starting in 2010, proxy statements were required to describe employee compensation policies and practices if risks arising from them "are reasonably likely to have a material adverse effect" on the company. As drafted, the rules do not require negative disclosure: if employee compensation policies and practices do not give rise to risks that are reasonable likely to have a material adverse affect on the company, a proxy statement can be silent on the issue of compensation risk. However, in comments on 2010 proxy statements for companies that did not include any disclosure in response to Item 402(s) of Regulation S-K, or that elected to provide negative disclosure indicating that their compensation policies did not create such risk, the SEC frequently requested supplemental descriptions of the process that was undertaken to reach such conclusion.

Leadership Structure. With respect to disclosure on leadership structure, the SEC's comments on 2010 proxy statements emphasized that providing the reasons why a company's leadership structure is appropriate given the company's specific characteristics or circumstances is needed whether the roles of

chairman and chief executive officer are separate or combined.

Specific Qualifications. The amended proxy disclosure rules required companies to describe the experience, qualifications, attributes or skills that led the board of directors to conclude that the nominee should serve as director. In comments to 2010 proxy statements, the SEC emphasized that such disclosure had to be specifically provided for each individual and that such detail had to be provided for all directors, not a sampling of directors and not just directors who are up for re-election in the current year.

Diversity. With respect to diversity policy, the SEC comments reminded companies of the necessity to disclose how the nominating committee or board assesses the effectiveness of the diversity policy. The SEC also raised comments where the disclosure mentioned diversity but did not clearly state how the committee or board considered diversity in indentifying candidates.

Compensation Consultants. When proxy statements disclosed that the compensation consultant used by the compensation committee, or its affiliates provided additional services to the company, the SEC indicated that future fillings should mention whether management decided or recommended such engagement.

Loss Contingency Standard

In July 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft titled "Contingencies (Topic 450): Disclosure of Certain Loss Contingencies" for comment. However, it does not appear that FASB will adopt a revised contingency loss disclosure rule in time to be applicable to annual reports for calendar years ending December 31, 2010.

At an FASB meeting held on November 10, 2010, the FASB staff summarized the comments on, and the major issues relating to, the exposure draft, but no decision was reached. FASB directed its staff to work with the staffs of the SEC and the Public Company Accounting Oversight Board to understand their efforts with respect to disclosure of certain loss contingencies through increased focus on compliance with existing rules. FASB also directed its staff to review filings for the 2010 calendar year-end reporting cycle to determine if those efforts have resulted in improved disclosures about loss contingences. FASB will begin re-deliberating on the exposure draft at a future meeting. For further information about FASB's proposal relating to loss contingencies, see our Legal Update dated September 16, 2010, titled "FASB Revises its Proposal Regarding Disclosure of Loss Contingencies."[14]

Changes in Broker Discretionary Voting

The Dodd-Frank Act prohibits brokers from voting uninstructed shares in the election of directors, executive compensation matters and other matters that the SEC determines significant. The NYSE and NASDAQ have adopted rules prohibiting broker discretionary voting in the election of directors. To comply with the Dodd-Frank Act, the NYSE and NASDAQ broker voting rules have been revised again to provide that brokers do not have discretionary voting rights on matters relating to executive compensation. The SEC has the authority to require brokers to be precluded from voting uninstructed shares in other significant matters. It currently plans to propose such rules in the April to July 2011 time frame.

Proxy Access

The SEC issued its final proxy access in August 2010 in Release Nos. 33-9136; 34-62764; IC-29384, titled "Facilitating Shareholder Director Nominations."[15] The proxy access rules were scheduled to become effective on November 15, 2010. However, the SEC granted a stay pending resolution of the petition that Business Roundtable and the Chamber of Commerce of the United States of America filed with the U.S.

Court of Appeals for the District of Columbia Circuit seeking review of the proxy access rules. It is not expected that proxy access rules will be effective in time for the 2011 proxy season for calendar year companies.

Public companies may want to use this extra time to consider the implications of the these rules. For example, companies with majority voting for directors should determine whether their applicable governing law and governing documents would apply a plurality voting standard if the total number of company and shareholder nominees exceeds the number of positions on the board that are up for election. It would also be advisable to examine provisions in governing documents or contracts, such as a "poison pill" shareholder rights plan, that incorporate the Section 13(d) group concept to determine the ramifications of shareholders forming a group to nominate a director pursuant to Rule 14a-11 under the Exchange Act. Companies should review existing advance-notice bylaw provisions and consider whether any amendments are warranted in light of proxy access. This review also provides an opportunity to consider whether an existing bylaw provision reflects the most current developments in advance-notice bylaw provisions.

It might also be prudent to consider adding procedures to their corporate governance guidelines to evaluate shareholder nominees. Some companies may wish to adopt, or amend, director qualification standards applicable to all nominees. Given the greater prospect of board seats being held by directors as representatives for different shareholder constituencies, companies may want to consider adopting corporate confidentiality, Regulation FD and conflict of interest policies that include directors, as an additional way to help protect the privacy of board deliberations and the confidentiality of material board information. For more detail on the SEC's proxy access rules, see our Legal Update dated September 7, 2010, titled "U.S. SEC Adopts Proxy Access Rules."[16]

Other Dodd-Frank Act Rulemaking

The SEC will be working on Dodd-Frank Act rulemaking throughout the next year. Much of this will not be effective for the 2011 proxy and annual report season. However, it is important to pay attention to these developments and to keep the board of directors informed of the status. See our Legal Update dated July 21, 2010, titled "Corporate Governance and Disclosure Implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act"[17] for additional information regarding the Dodd-Frank Act.

Compensation Committee Independence. The Dodd-Frank Act requires the SEC and the stock exchanges to adopt rules regarding compensation committee member independence by July 16, 2011. The SEC's proposed rules are currently scheduled to be released in December 2010. Although these rules will not be effective until after most calendar-year companies have completed their 2011 annual meetings, nominating and governance committees would be well advised to consider the proposed rules when recommending board nominees and board committee assignments.

Compensation Consultants. The SEC also plans to issue its proposed factors affecting compensation adviser independence and disclosure rules on compensation consultant conflicts in December 2010. Like the compensation committee independence rules, the final rules regarding compensation consultant conflicts need to be effective by July 16, 2011. Close attention should be paid to the proposed rules, when issued, to allow time to react and adjust to the pending rules in this area.

Pay-for-Performance, Internal Pay Comparison, Hedging and Clawbacks. The Dodd-Frank Act requires the SEC to adopt rules regarding pay-for-performance disclosures (comparing executive pay with company performance), internal pay comparison disclosures and hedging policy disclosures.

However, the Dodd-Frank Act did not provide a specific effective date for these rules and they will not apply to the upcoming proxy season. The SEC plans to propose rules sometime between April and July 2011. In that same time frame, the SEC plans to issue a proposal to implement the Dodd-Frank Act requirement that the SEC and the stock exchanges adopt rules regarding incentive pay clawback provisions.

Specialized Disclosures. The SEC is expected to propose disclosure requirements relating to "conflict minerals," mine safety information and resource extraction issuers in December 2010. Final rules are currently expected to be adopted in the April to July 2011 time frame. Therefore, such disclosure is not needed in annual reports for the year ended December 31, 2010.

Vote Reporting by Institutional Investment Managers. In October 2010, the SEC proposed rules requiring institutional investment managers to disclose how they voted on executive compensation. See Release Nos. 34-63123; IC-29463, titled "Reporting of Proxy Votes on Executive Compensation and Other Matters."[18] Final rules are planned for the January to March 2011 time frame. Such reports are to be made by August 31 of each year for the most recent 12-month period ended June 30. These reports on Form N-PX will be a resource for company to determine how some of these large institutional shareholders feel about their executive compensation program. A review of these reports, when available, may suggest where targeted investor reach-out on executive compensation issues may be productive.

SEC's Whistleblower Program. The Dodd-Frank Act also requires the SEC to establish a whistleblower program requiring the SEC to pay awards to eligible whistleblowers who voluntarily provide the SEC with original information about a violation of federal securities laws that leads to the successful enforcement of a covered judicial or administrative action. In November 2010, the SEC issued Release No. 34-63237, titled "Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934."[19]

The SEC recognizes the important role played by corporate compliance departments and has indicated that it is not trying to undermine internal reporting programs. In fact, the SEC has proposed—as a consideration in determining the amount of a whistleblower award—whether, and the extent to which, a whistleblower reported the potential violation through the company's internal compliance procedures before reporting the violation to the SEC. While such internal reporting is not proposed to be a requirement under the SEC's whistleblower bounty program, the SEC has indicated that it will consider higher percentage awards for whistleblowers who first report violations through their compliance programs.

In light of this upcoming Dodd-Frank Act mandated government whistleblower program, public companies may want to evaluate their existing internal compliance programs and consider whether it should reference, or otherwise be modified to be in alignment with the SEC's program. Comments on this whistleblower bounty program are due on December 17, 2010. Final rules are expected to be adopted in the January to March 2011 time frame.

Proxy Plumbing

In July 2010, the SEC issued a "Concept Release on the U.S. Proxy System," Release Nos.34-62495; IA-3052; IC-29340,[20] addressing "proxy plumbing," i.e., infrastructure and related technical issues affecting the solicitation, tabulation and voting of proxies. This project has not yet reached the proposal stage so potential changes in this area will not affect the upcoming proxy season. However, people involved in the proxy process should be aware of the discussions in this area. Also, because the concept release summarizes the existing mechanics of proxy

solicitation and tabulation, it is a useful resource for people who are involved in the proxy process. For a more detailed discussion of the proxy plumbing concept release, see our Legal Update, dated August 18, 2010, titled "U.S. Securities and Exchange Commission's Proxy Plumbing Concept Release."[21]

Endnotes

[1] Available at http://www.sec.gov/rules/proposed/2010/33-9153.pdf.

[2] Available at http://www.mayerbrown.com/publications/article.asp?id=9905&nid=6.

[3] Available at http://www.sec.gov/rules/interp/2010/33-9144.pdf.

[4] Available at http://www.mayerbrown.com/securities/article.asp?id=9684&nid=10707.

[5] Available at http://www.sec.gov/rules/proposed/2010/33-9143.pdf.

[6] Available at http://www.mayerbrown.com/securities/article.asp?id=9747&nid=10707.

[7] Available at http://www.sec.gov/rules/interp/2010/33-9106.pdf.

[8] Available at http://www.mayerbrown.com/securities/article.asp?id=8535&nid=10707.

[9] Available at http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm.

[10] Available at http://www.sec.gov/spotlight/xbrl/staff-review-observations-110110.shtml.

[11] Available at http://www.sec.gov/spotlight/xbrl/staff-interps.shtml.

[12] Available at http://www.mayerbrown.com/securities/article.asp?id=6186&nid=10707.

[13] Available at http://www.mayerbrown.com/securities/article.asp?id=8373&nid=10707.

[14] Available at http://www.mayerbrown.com/securities/article.asp?id=9646&nid=10707.

[15] Available at http://www.sec.gov/rules/final/2010/33-9136.pdf.

[16] Available at http://www.mayerbrown.com/publications/article.asp?id=9600&nid=6.

[17] Available at http://www.mayerbrown.com/securities/article.asp?id=9371&nid=10707.

[18] Available at http://www.sec.gov/rules/proposed/2010/34-63123.pdf.

[19] Available at http://www.sec.gov/rules/proposed/2010/34-63237.pdf.

[20] Available at http://www.sec.gov/rules/concept/2010/34-62495.pdf.

[21] Available at http://www.mayerbrown.com/securities/article.asp?id=9496&nid=10707.

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