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Preparing for the 2012 Proxy and Annual Reporting Season

Before the year draws to a close, public companies should begin planning for the 2012 proxy and annual reporting season. Key issues for the upcoming season are summarized below.

Say-on-Pay

Public companies now have a year of mandatory say-on-pay experience to draw upon. While shareholders for the most part approved their companies' executive compensation, often by wide margins, there are lessons that can be learned from the 2011 vote, and steps that can be taken to improve presentation.

It would be worthwhile for an investor relations department to contact any large shareholders that voted against executive compensation to discuss the reasons for the negative vote. This should be in the nature of a dialogue about the investor's concerns, rather than a solicitation for the next say-on-pay vote. This conversation is timely now, even for companies that will not be conducting a say-on-pay vote in the 2012 season. Say-on-pay gave shareholders only the option to vote for or against the entire executive compensation package, as disclosed in the proxy statement. If companies want to know which particular elements of compensation particular shareholders found objectionable, they need to ask them.

In the compensation discussion and analysis (CD&A) section of their proxy statements, companies now need to discuss the extent to which compensation decisions were impacted by the results of the say-on-pay vote. While there is some precedent for such disclosure in proxy statements of companies that received government money under the Troubled Asset Relief Program (TARP), this is a new requirement for companies that held their first mandatory say-on-pay vote in 2011. Compensation committees should be made aware of this requirement so that their deliberations can, if they so choose, specifically address the results of the say-on-pay advisory vote. However, compensation committees are not compelled to take any actions in response to the shareholder advisory vote because the say-on-pay vote is non-binding. If compensation committees want the CD&A to report that the committee took say-on-pay results into account, action items for this proxy season should be to include consideration of the say-on-pay vote in the compensation committee's agenda, and to develop disclosure responsive to this requirement and circulate it to management and compensation committee members.

Companies should review how their executive compensation was presented in last year's proxy statement and compare it to how their peers presented compensation. Key questions to consider include how clearly the overall rationale for the compensation program was explained to shareholders and whether the ties, if any, between performance and compensation were adequately and consistently explained. While there is a tendency to use the prior CD&A as a starting place, it is important to see if its advocacy role in the say-on-pay context can be improved.

Executive summaries at the beginning of the CD&A are becoming more common, and those sections in particular need to be updated to highlight the most current indicia of company performance and how compensation decisions reflected them.

Companies and their compensation committees should consider whether any substantive changes should be made to their compensation programs to encourage more favorable say-on-pay votes. For example, some companies may decide to eliminate tax gross-ups, which represent a discrete part of a compensation package that generates criticism from some shareholders and proxy advisory firms.

Companies should be aware that litigation has been filed against a number of companies where say-on-pay votes failed to garner majority approval. While it is not clear whether any of these lawsuits will prevail on the merits, the legal and settlement costs of litigation can be expensive and may hurt the reputations of the defending companies and their compensation committee members.

Say-When-On-Pay

Because the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) only requires that companies ask shareholders to vote once every six years on the frequency of say-on-pay votes, most companies will not include a frequency proposal in this year's proxy statement.

Companies must disclose the frequency of say-on-pay vote policy they have adopted after taking into account the shareholder advisory say-when-on-pay vote. This is different than a voting recommendation with respect to the non-binding say-when-on-pay proposal included in the proxy statement for the 2011 meeting. This disclosure reflects the company's decision on how often it will conduct a say-on-pay vote until the next time it submits the frequency question to shareholders for a vote.

The frequency policy must be disclosed no later than 150 calendar days after the annual meeting, but at least 60 calendar days prior to the company's deadline for submission of shareholder proposals under Rule 14a-8 for the next annual meeting. This disclosure is generally accomplished by an amendment to the Form 8-K that reported voting results pursuant to Item 5.07. It can also be disclosed in a Form 10-Q or Form10-K filed within the deadline for the amendment.

Compensation Committee Independence and Compensation Consultants

The Dodd-Frank Act requires the Securities and Exchange Commission (SEC) to adopt rules directing the national securities exchanges to prohibit the listing of equity securities of any issuer not in compliance with the compensation committee independence and the compensation adviser requirements set forth in the Dodd-Frank Act, and to adopt disclosure rules concerning compensation consultants and conflicts of interest. On March 30, 2011, the SEC proposed rules to implement these requirements.

Tracking the statutory language of the Dodd-Frank Act, the SEC proposed Rule 10C-1 under the Securities Exchange Act of 1934 (Exchange Act), which requires the exchanges to consider relevant factors when determining independence requirements for compensation committee members, including the source of a board member's compensation (such as any consulting, advisory or other compensatory fee paid by the issuer to such board member) and whether a board member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer. The exchanges may also consider other factors in determining independence requirements, subject to the SEC's approval process for exchange listing standards.

Proposed Rule 10C-1 specifies that compensation committees may only retain compensation consultants, independent legal counsel and other advisers after taking into consideration the

following factors, as well as any other factors identified by the relevant exchange in its listing standards:

- The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser.
- The amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser.
- The policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest.
- Any business or personal relationship of the compensation consultant, legal counsel or other adviser with any member of the compensation committee.
- Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser.

The SEC also proposed an amendment to Item 407 of Regulation S-K that would integrate the Dodd-Frank Act disclosure requirements relating to compensation consultants and conflicts of interest with existing proxy statement compensation consultant disclosure requirements. The revised disclosure requirement will relate to all companies subject to the SEC's proxy rules, whether or not they are listed and without regard to whether they are "controlled companies" as defined in Section 10C(g)(2) of the Exchange Act.

Under this amendment, companies will have to disclose whether the compensation consultant's work raised a conflict of interest. If it did, the nature of the conflict of interest and how it is being addressed will have to be described. In determining whether a conflict of interest exists for disclosure purposes, companies should consider the above-described factors that the Dodd-Frank Act and proposed Rule 10C-1 require compensation committees to consider when hiring compensation consultants. As proposed, there will not be a carve-out for advice on broad-based plans or the provision of non-customized benchmark data. These matters may be considered conflicts of interest that would have to be described in the company's proxy statement.

The SEC plans to adopt final rules regarding compensation committee independence and compensation consultant in 2011. However, even if they do, the implementation of the actual listing standards will require further action by the stock exchanges. Therefore, new listing standards affecting compensation committee members may not be in place for some time after the SEC issues its final rules. Nevertheless, once the final rules are published, companies should consider whether the new rules impact any current member of the compensation committee. Ultimately, companies will need to pay attention to listing standards that are proposed and adopted in response to the final SEC rules.

The compensation consultant conflict of interest disclosures will not be required before the effective date of the SEC's final rule. It is not clear when that will be. For further details about the proposed rules see our April 6, 2011 Legal Update, "SEC Proposes Compensation Committee Listing Standards and Compensation Consultant Disclosure Requirements as Mandated by the Dodd-Frank Act."[1]

Other Pending Dodd-Frank Regulation

Pay-for-Performance. The Dodd-Frank Act requires the SEC to adopt rules regarding pay-for-performance pursuant to which companies will have to disclose material information that shows the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the shares of stock and the dividends of the company. The SEC has not yet proposed rules for this disclosure requirement, although it has indicated that it

plans to do so before the end of 2011. The SEC currently plans to adopt final rules in the January to June 2012 time frame. However, given that the proposals have not yet been issued, it seems unlikely that this rule will impact the 2012 proxy season. Nevertheless, it is important to monitor this pending regulation because it is possible that the final disclosure requirements might influence decisions taken by compensation committees during 2012.

Internal Pay Comparison. The Dodd-Frank Act also requires an internal pay comparison, disclosing the median of the annual total compensation of all employees of the company except the CEO, the annual total compensation of the CEO and the ratio of the two numbers. As with pay-for performance, the proposed rules are currently expected by the end of 2011, with the final rules planned for the January to June 2012 time frame.

Although the internal pay comparison rules are not likely to be required in 2012 proxy statements for calendar year companies, all companies should follow this rulemaking very carefully. Many companies, particularly global companies, are likely to find the new requirement challenging to implement. It is possible that various employment databases will need to be coordinated and that information will have to be gathered for all employees in a different fashion than is currently in use. It is not clear what effective date the SEC will adopt for this new requirement, but it will take planning and time for companies to achieve compliance with its requirements.

Hedging. The SEC still needs to propose regulations to implement the Dodd-Frank Act requirement for companies to disclose whether employees or directors are permitted, directly or indirectly, to hedge market value of securities granted as compensation. Again, the proposal is currently planned by the end of 2011, with the final rules expected to be adopted in the January to June 2012 time frame. Of course, companies are already required to disclose any policies regarding hedging the economic risk of owning company securities pursuant to Item 402(b)(2)(xiii) of Regulation S-K. It generally makes sense for the rules to be finalized before adopting or amending a hedging policy that is designed to be responsive to the Dodd-Frank Act hedging requirement.

Clawbacks. Under the Dodd-Frank Act, the SEC must direct stock exchanges to prohibit listing if a company does not develop a policy with respect to recovery of incentive-based compensation. Unlike the comparable Sarbanes-Oxley Act provision, under the Dodd-Frank Act the clawback policy will need to cover both current and former executive officers, not just the CEO and the CFO. The Dodd-Frank Act clawback provision applies to any accounting restatement due to material non-compliance, whether or not the executive officer is responsible for the misconduct that led to the misstatement. The proposed SEC clawback rules are expected before the end of 2011 and the SEC plans to issue the final rules in the January to June 2012 time frame. Thereafter, there will be additional stock exchange rulemaking. This is another important area to follow closely, although companies may wait for the final rules before adopting or amending a clawback policy for the purposes of complying with this Dodd-Frank Act requirement.

Proxy Access and Shareholder Proposals

The U.S. Court of Appeals for the District of Columbia vacated SEC Rule 14a-11 under the Exchange Act, which would have required public companies to include shareholder nominees for director in company proxy materials in certain circumstances. The SEC did not seek a rehearing of the decision or attempt to appeal the decision to the Supreme Court, and the court order became effective on September 14, 2011.

When the SEC adopted Rule 14a-11, it also amended Rule 14a-8, the shareholder proposal rule. This amendment, as well as the other rule changes contained in the SEC's final proxy access

release other than vacated Rule 14a-11, became effective on September 20, 2011. Before Rule 14a-8(i)(8) was amended, companies were permitted to exclude from their proxy statements shareholder proposals relating to a nomination or an election for membership on the company's board of directors or analogous governing body, *or a procedure for such nomination or election*. As amended, Rule 14a-8(i)(8) no longer provides a basis for companies to exclude from their proxy materials shareholder proposals to amend the companies' governing documents relating to nomination procedures or disclosures relating to shareholder nominations.

This rule change does not affect Rule 14a-8(i)(2), which provides a separate basis for excluding a shareholder proposal that violates state law. Therefore, the shareholder proposal process under Rule 14a-8 cannot be used to avoid or restrict requirements of state law. Subject to that limitation, amended Rule 14a-8(i)(8) will permit proposals relating to nomination procedures that may not reflect the ownership thresholds, holding periods or other provisions that had been contained in Rule 14a-11.

The amendments to Rule 14a-8(i)(8) also codify certain prior staff positions permitting exclusion of a proposal if it:

- Would disqualify a nominee who is standing for election.
- Would remove a director before the expiration of that director's term.
- Questions the competence, business judgment or character of any nominee.
- Seeks to include a specific individual in the company's proxy materials for election to the board of directors.
- Could otherwise affect the outcome of the upcoming election of directors.

Specialized Disclosures

Conflict minerals. The Dodd-Frank Act requires the SEC to adopt rules requiring annual and website disclosure when "conflict minerals" are necessary to the functionality or production of a product manufactured by a company that files periodic reports under the Exchange Act. Conflict minerals are defined as columbite tantalite (also known as coltan and from which tantalum is extracted), cassiterite (from which tin is extracted), gold, wolframite (from which tungsten is extracted) or their derivatives or any other mineral or its derivatives determined to be financing conflict in the Democratic Republic of Congo or an adjoining country.

The SEC proposed rules in December 2010 to implement this provision and is hosting a public roundtable on October 18, 2011 to discuss this rulemaking. Final rules have not yet been adopted, but the SEC has indicated that it expects to do so before the end of 2011.

Because the Dodd-Frank Act specified that issuers would have to provide their initial conflict minerals disclosure and, if necessary, their initial conflict minerals report after their first full fiscal year following the promulgation of the SEC's final rules, it is not likely that the conflict minerals disclosure will impact annual reports for the 2011 calendar year. However, there was a legislative intent to have the final rules effective by April 15, 2011, which would have made the conflict minerals disclosure or report for calendar year companies due after the December 31, 2012 fiscal year. However, it may be time-consuming for affected companies to gather the necessary material. Therefore, companies that use conflict minerals should pay close attention to the final rules once released.

Mine Safety. The Dodd-Frank Act requires companies that filed periodic reports under the Exchange Act to disclose mine safety and health standards in their annual and quarterly reports filed with the SEC. In addition, mining companies that are subject to Form 8-K requirements must file a Form 8-K when they receive certain notices from the Mine Safety and Health Administration. This Dodd-Frank Act disclosure requirement is already in effect. The

SEC issued proposed rules in December 2010 to address the scope and application of the mine safety disclosure requirements and expects to issue final rules before the end of 2011. Because the Dodd-Frank Act requirement is already in effect, companies involved in mine safety should be prepared to incorporate any changes in the final SEC rules into their upcoming annual (and quarterly reports), as well as Form 8-K filings.

Resource Extraction Issuers. The Dodd-Frank Act requires resource extraction issuers to include in their annual reports information regarding payments to a foreign government or the U.S. federal government for commercial development of oil, natural gas or minerals. The SEC issued proposed rules relating to resource extraction issuers in December 2010 and expects to issue final rules before the end of 2011.

Under the proposed rules, issuers that are required to file an annual report with the SEC, and that engage in the commercial development of oil, natural gas or minerals, will have to disclose, under an appropriately captioned section of their annual reports, non-*de minimis* payments made to a foreign government, including sub-national governments, or to the U.S. federal government, that are made to further the commercial development of oil, natural gas or minerals.

The Dodd-Frank Act specified that final rules relating to resource extraction issuers would take effect for annual reports for the fiscal year ending not earlier than one year after the date on which the SEC issues its final rules on this subject. Therefore, it does not appear that the final rules, once issued, would impact annual reports for fiscal years ending December 31, 2011. However, the Dodd-Frank Act required the SEC to finalize its rules by April 15, 2011, so it may have been the intention of that Act to require disclosure in an issuer's annual report relating to fiscal years ending on or after April 15, 2012. Resource extraction issuers should follow this rulemaking to determine what changes the SEC makes from the proposed rules and what the effective date will be.

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. The SEC's most current calendar indicates that final rules will be adopted by the end of 2011. Such reports are to be made by August 31 of each year for the most recent 12-month period ended June 30. While this reporting requirement will not be effective in time to provide information that will be useful to companies preparing for the 2012 proxy season, once they become available these reports on Form N-PX will be a resource for a company to determine how some of these large institutional shareholders feel about a company's executive compensation program. A review of these reports, when available, may suggest where targeted investor reach-out on executive compensation issues may be productive, which may help say-on-pay votes for the 2013 proxy season.

Recent SEC Interpretations

In 2010, the SEC issued a number of interpretations that, while not new, remain relevant and should be considered when preparing annual disclosures. For example, 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,"[2] 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). In this release, the SEC identified the following as examples of important trends or uncertainties impacting liquidity that could require disclosure in the MD&A:

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. 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.

The SEC's Division of Corporation Finance sent letters to certain public companies in October 2010 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.[3] If mortgages and foreclosure activities are important to a company's business, it should address in its annual report the issues the SEC raised in this letter, whether or not it received such a letter.

In 2010, the SEC also issued Release Nos. 33-9106; 34-61469, titled "Commission Guidance Regarding Disclosure Related to Climate Change."[4] Based on this guidance companies should continue to review whether they need to add, supplement or modify climate change disclosure in their upcoming annual report.

XBRL

The phase-in of eXtensible Business Reporting Language (XBRL) is well underway. The staff of the SEC's Division of Risk Strategy and Financial Innovation has published several small observations from reviews of interactive financial data, the most recent in June 2011.[5] These reports provide useful guidance regarding practices for implementing XBRL. In addition, both the Division of Corporation Finance and the Office of Interactive Disclosure have published FAQs.[6]

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,[7] addressing "proxy plumbing," i.e., infrastructure and related technical issues affecting the solicitation, tabulation and voting of proxies. Although comments have been submitted, this project has still not yet reached the proposal stage, so potential changes in this area should 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 August 18, 2010 Legal Update, "U.S. Securities and Exchange Commission's Proxy Plumbing Concept Release."[8]

Endnotes

1 Available at http://www.mayerbrown.com/fsre/article.asp?id=10764&nid=706.

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

3 Available at http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm.

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

5 See http://www.sec.gov/spotlight/xbrl/staff-review-observations-061511.shtml.

6 See http://www.sec.gov/divisions/corpfin/guidance/interactivedatainterp.htm and http://www.sec.gov/spotlight/xbrl/staff-interps.shtml.

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

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

If you have any questions regarding the 2012 proxy and annual report season, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the lawyers listed below or any other member of our Corporate & Securities group.

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