Preparation of Annual Disclosure Documents

Session II: Preparation of Proxy Statements

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Proxy Solicitation Process

- Regulated by
  - Federal securities laws
    - Manner in which proxy solicitation may be made
    - Form and content of soliciting materials
    - Manner in which communications made
  - State corporate law
    - Who may vote (e.g., record dates)
    - Notice and calling of meeting
  - Exchange and NASDAQ rules
    - Various form and notice requirements
Proxy Solicitation Process

- Time and responsibilities should be determined
- Any shareholder proposals should be reviewed and determination made to include or to seek permission to exclude
- Directors and officers questionnaires should be prepared and distributed
- Audit committee should review all questionnaires for potential conflicts or audit disclosure
- Record date should be established
- Broker search cards must be sent
- Draft proxy statement should be reviewed by board and management
- Board should approve proxy statement and adopt necessary resolutions
- Preliminary proxy materials may need to be filed with the SEC
- Final proxy materials need to be filed with the SEC
Proxy Solicitation Process

- Rule 14a-13(a) provides that, where a company knows that brokers, dealers, banks or other entities or clearing agencies hold of record its voting securities, and the company is soliciting proxies, it must:
  - Inquire (using first class mail or other "equally prompt means") at least 20 calendar days (except in the case of special meetings where 20 calendar days may be impractical) prior to the record date whether they are the beneficial owners; and
  - If not,
    - Ask how many copies of the proxy materials and annual reports are necessary for distribution to such beneficial owners;
    - Ask the name and address of any agent designated to fulfill their obligations to provide the company with names, addresses and security holdings of non-objecting beneficial owners (NOBOs), and
    - Indicate whether the registrant will deliver its annual report to NOBOs.
Proxy Solicitation Process

- The company is required to supply the brokers and banks "in a timely manner" with such quantity of such materials, assembled in such form and at such place and time, as may have reasonably been requested by the brokers and banks.
- The company is also required to pay each broker's or bank's reasonable expenses for mailing such material, if so requested.
- Brokers and banks are required to complete the mailings to beneficial owners within five business days of receipt of the materials for mailing.
Proxy Solicitation Process

- Electronic Delivery
  - See Releases 34-36345 (October 6, 1995); 34-37182 (May 9, 1996); 34-37183 (May 9, 1996)
  - The releases set forth a number of illustrations of permissible and impermissible electronic delivery methods for proxy materials and annual reports by both companies and intermediaries
    - One illustration concludes that a registrant has complied with the proxy rules if it places its annual report and proxy soliciting materials on its website and provides notice to all recordholders who had previously consented to web delivery, instructing them of the documents' availability and to print, execute and mail in the proxy card
Proxy Solicitation Process

- Preliminary proxy materials must be filed with the SEC at least ten calendar days prior to the distribution of definitive copies of those materials
  - All preliminary materials must be clearly marked “preliminary copies” and accompanied by a statement of the date on which definitive materials are intended to be released to security holders
- The filing of revised material does not recommence the ten day time period unless the revised materials contain material revisions or new proposals that constitute a fundamental change in the proxy material
- Preliminary proxy materials need not be filed if the solicitation relates to an annual meeting, or a special meeting in lieu of the annual meeting, and the only matters to be acted upon at the meeting are
  - The election of directors
  - The election, approval or ratification of accountants
  - A security holder proposal included pursuant to Rule 14a-8
  - The approval of an employee benefit plan
Proxy Solicitation Process

- Definitive proxy materials and all other soliciting materials must be filed with the SEC not later than the date on which materials are first distributed to security holders.
- Three copies of the materials must simultaneously be filed with each national securities exchange on which any class of the issuer's securities is listed and registered (though the exchanges have waived this requirement).
- If the solicitation is to be made in whole or in part by personal solicitation, all written materials to be given to the individuals making the actual solicitation must be filed with the SEC no later than the date any such material is first sent to such individuals.
Nomination Guidelines

- Starting in 2004, information concerning nominating procedures is required in proxy statements
- Specific disclosures are required concerning nominating committee
- Disclosure of policy relating to consideration of director candidates recommended by shareholders
  - Description of procedures a shareholder needs to follow
  - Minimum qualifications that director candidates must have
- Description of nominating committee’s procedure for identifying and evaluating candidates
- Disclosure of who recommended a candidate
- Include any disclosure specific to the company such as a by-law provision regulating the shareholder nomination process
Hot Topics for Shareholder Proposals

- Shareholder Access
- Executive Compensation
- Governance
- Social Issues
Requirements of Rule 14a-8

- Procedural Requirements
  - Share ownership
  - One proposal limit
  - Supporting statement
  - Deadline for submission
- Reasons that proposals may be excluded
  1) Improper under state law
  2) Violation of law
  3) Violation of proxy rules
  4) Personal grievance
  5) Relevance
  6) Absence of power/authority
  7) Management functions
  8) Relates to election
  9) Conflicts with company's proposal
  10) Substantially implemented
  11) Duplication
  12) Resubmissions
  13) Specific amount of dividends
Other Issues in Responding to Shareholder Proposals

- Staff Legal Bulletin 14B which came out in September of 2004 clarified and limited the basis under which a company can exclude proposals as false and misleading under Rule 14a-8(i)(3)
  - The company may use its statement in opposition to address factual assertions in the proponent’s statement of support for its proposal
- Rule 14a-8(i)(3) may be used to exclude or modify a proposal or supporting statement that impugns character or reputation
- Rule 14a-8(j) requires a company to file its reasons for excluding a shareholder proposal with the SEC no later than 80 calendar days before the company files its definitive proxy statements
- Disclaimers of responsibility for the content of shareholder proposals
- Negotiations as a means of deflecting shareholder proposals
Audit Committee Disclosures in the Proxy Statement

- Item 7(d)(3)(i) of Schedule 14A requires:
  - Reg S-K Item 306 information
  - Information regarding audit committee charter
  - Audit committee independence
Audit Committee Disclosures in the Proxy Statement

- Reg S-K Item 306 requires the audit committee to state whether it has
  - Reviewed and discussed the audited financial statements with management
  - Discussed with the independent auditors the matters required to be discussed by SAS No. 90 (formerly SAS61)
  - Received the written disclosure and the letter required by Independence Standards Board Standard No.1 and discussed with the independent accountant its independence
  - Based on the above, recommended to the board that the audited financial statements be included in the company’s Form 10-K

- Item 306 also requires disclosure of the name of each member of the audit committee
Audit Committee Disclosures in the Proxy Statement

- Audit committee report Reg S-K Item 306 information must be presented in the proxy statement under the caption “Audit Committee Report”

- Placement is up to the company
  - With other committee reports
  - Directly before ratification of auditors

- Audit committee report is not considered “soliciting material” or “filed” with the SEC unless specifically requested
Audit Committee Disclosures in the Proxy Statement

- Schedule 14A requires disclosure as to whether the audit committee has a charter
  - NYSE and NASDAQ rules require audit committees to have charters

- A copy of the audit committee charter must be included as an appendix unless it has been included as an appendix with the past three fiscal years
  - If the charter has been modified since being included as an appendix in a prior proxy statement, then the entire charter, as amended, should be included as an appendix.
Audit Committee Disclosures in the Proxy Statement

- If the company is a “listed issuer”
  - The company must disclose whether the audit committee members are “independent” under applicable listing requirements
  - And if the company’s board determines, in accordance with applicable listing standards, to appoint a non-independent audit committee member, the company must disclose the nature of the relationship that conflicts with independence and the reasons that such non-independent persons have nonetheless been appointed
Audit Committee Disclosures in the Proxy Statement

- The company must disclose if the company’s board of directors has determined that the registrant either:
  - Has at least one audit committee financial expert ("ACFE") serving on its audit committee; or
  - Does not have an ACFE serving on its audit committee

- If the company has at least one ACFE, the company must disclose the name of the ACFE and whether that person is independent
  - If the company has more than one ACFE serving on its audit committee, it may, but is not required to, disclose the names of the additional persons. If it does name the additional ACFEs, it must disclose if all of them are independent

- If the company does not have an ACFE, it must explain why it does not have an ACFE
Audit Committee Disclosures in the Proxy Statement

- An ACFE means a person who has the following attributes:
  - An understanding of GAAP and financial statements
  - The ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves
  - Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities
  - An understanding of internal control over financial reporting, and
  - An understanding of audit committee functions
Audit Committee Disclosures
in the Proxy Statement

- An ACFE can obtain the necessary experience through:
  - Education and experience as a CFO, CAO, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions
  - Experience actively supervising a CFO, CAO, controller, public accountant, auditor or person performing similar functions
  - Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements, or
  - Other relevant experience

- Investment professionals?
Audit Committee Disclosures in the Proxy Statement

- A person who is determined to be an ACFE will not be deemed an “expert” under Federal securities laws as a result of being designated or identified as an ACFE.
- The designation or identification of a person as an ACFE does not impose on that person any duties, obligations or liability that is greater than the duties, obligations and liability imposed on any other member of the audit committee and board.
- The designation or identification of a person as an ACFE does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.
Audit Committee Disclosures in the Proxy Statement

- If, in the past two years, an auditor has resigned, been dismissed by the audit committee or declined to stand for election, the company must disclose
  - the basis for the resignation or dismissal
  - whether their audit reports included any adverse views or limits as to the company’s financials and
  - whether there were any disagreements between the auditor and the company as to financial and accounting principles, practices or disclosures and the nature of those disagreements
Audit Committee Disclosures in the Proxy Statement

- Companies are required to disclose the fees paid to their auditors, broken down into the following four categories:
  - **Audit Fees.** Services necessary to perform audit in accordance with auditor standards, statutory and regulatory filings or engagements, and other services generally provided by independent auditors, including comfort letters
  - **Audit-Related Fees.** Assurances and due diligence services, including employee benefit plan audits, M&A due diligence and internal control reviews
  - **Tax Fees.** Services performed by professional staff in accounting firm’s tax division, except audit services, including tax compliance, planning and advice.
    - Note. In view of the ISS position referenced below, the tax fees should be clearly broken down into tax compliance and preparation as distinguished from tax advice, planning, consulting, etc.
  - **All Other Fees.** Other fees, including financial information systems and implementation and design
Audit Committee Disclosures in the Proxy Statement

- Practical considerations
  - Using a table may make disclosure more readable
  - SOX 404 fees are included in “audit fees”
  - Information must now be provided for the last two fiscal years
  - Other than “audit fee” work, a description of the nature of the service provided must be provided
  - Consider whether to disclose fees paid to other accounting firms for SOX 404 work
Audit Committee Disclosures in the Proxy Statement

ISS currently recommends voting against ratification of auditors and withholding votes in support of the election of directors who are the members of the audit committee if non-audit fees are excessive, as indicated by the following formula based on the SEC’s disclosure designations:

- Non-audit (“other”) fees > audit fees + audit-related fees + tax compliance/preparation fees

For this purpose, tax compliance and preparation include the preparation of original and amended tax returns, claims for refunds and tax payment planning. All other services in the tax category are added to other, non-audit fees. If the disclosure is such that the ISS cannot distinguish which fees are for tax compliance and preparation as compared to tax advice, planning, consulting, etc., then all the fees in the tax category are included in the “other” fees. ISS urges companies to include, in their tax fee footnote, a breakout of the amount of fees related to tax compliance and preparation fees as compared to all other tax fees.
Audit Committee Disclosures in the Proxy Statement

- Companies must disclose
  - Audit committee’s pre-approval policies and procedures
  - Percentage of the fees under each of the four categories that were pre-approved by the audit committee

- If greater than 50%, the company must disclose the percentage of hours expended on the principal accountant’s engagement to audit the registrant’s financial statements for the most recent fiscal year that were performed by persons other than the accountant’s full-time permanent employees
Director Independence Determinations

- Stock exchange rules require that the board of directors must determine the independence status of directors
  - Independence determinations are needed both for NYSE and NASDAQ companies
- The basis for each determination must be disclosed in the proxy statement
- Independence disclosure can be done by reference to categorical standards of independence to the extent applicable
- If a relationship is not addressed by the categorical standards, specific disclosure will be needed in the proxy statement
- The independent directors must be specifically identified in the proxy statement
Categorical Standards of Director Independence

- On November 3, 2004, amendments to the NYSE bright line tests for director independence were approved.

- To the extent that the pre-existing NYSE independence tests were included as part of a company’s categorical standards of director independence, those standards should be updated.

- The primary changes to the NYSE bright line tests include:
  - Relationship with auditors test has changed so that the three year look-back applies only if the director or family member personally worked on the audit.
  - Look-back for $100,000 compensation clarified as 36 months.
  - Executive officer definition clarified as officer under Section 16a-1(f).
  - Status as a former interim executive officer of any type (not just CEO) does not impact independence determination.
Categorical Standards of Director Independence

- NASDAQ independence rules were amended in June 2004, clarifying that payments made by financial institutions to their directors and their families do not count towards the $60,000 NASDAQ bright line independence test if they are:
  - Loans made in the ordinary course of business, on non-preferential terms, with a normal degree of risk and not subject to the specific disclosure requirements of Item 404 of Regulation S-K
  - Payments in connection with deposit of funds or the financial institution acting in an agency capacity, made in the ordinary course of business, on non-preferential terms and not subject to the specific disclosure requirements of Item 404 of Regulation S-K
Contacting the Board

- NYSE listed companies must have a method to communicate with the presiding directors or with the non-management directors as a group
- While the same procedure may be used to contact the board of directors and the independent directors, the disclosed procedures should make clear that the method may be used to contact the presiding director or the independent directors
- The SEC’s proxy rules require disclosure of whether or not the company has a process for security holders to send communications to the board of directors
  - The manner in which security holders may send communications must be described
  - If a company does not have such a process, the proxy rules require disclosure of the board’s basis for its view as to why it is appropriate not to have such a process
- If all security holder communications are not sent to directors, the proxy rules require disclosure of the process for determining which communications are relayed to directors
- If a majority of the independent directors approve a process for collecting and organizing security holder communications, that process does not need to be disclosed
Contacting the Board

- Proxy rules also require a description of the company’s policy regarding director attendance at Board meetings
- Sarbanes/Oxley and related rules require the audit committee to establish confidential and anonymous procedures for receipt of accounting, internal control and auditing concerns
Executive Sessions

- NYSE rules require that non-management directors must meet in regularly scheduled annual sessions.
- At least once a year, the executive sessions must be limited to independent directors.
- A non-management director must preside at each executive session of non-management directors, although the same director does not need to preside at each session.
- The proxy statement must disclose who presides at executive sessions or the manner in which any rotation of the presiding responsibilities is rotated.
Updated ISS Voting Guidelines
Governance Related

- Withholding of votes where the CEO sits on more than two outside board seats
- Ex-officers who remain on the board to be considered independent after 5 years (as opposed to “affiliated outsiders”)
  - Not the case for former CEOs
- Limited the meaning of relative in the independence context to immediate family members
- Withholding of votes from directors of companies that adopt poison pills without shareholder approval since the last annual meeting unless the pill will be submitted for shareholder approval within 12 months of adoptions
  - December 7, 2004 effective date
- ISS may vote against proposals to separate the chairman and CEO provisions even if there is a lead director if performance is poor
Updated ISS Voting Guidelines
Compensation Related

- ISS recommends voting against equity plans that have high average three-year burn rates
- ISS will generally recommend voting for director equity plans, but if there are excessive costs, ISS will recommend the plans only if specified qualitative features are met
- ISS values stock options with liberal share counting provisions and SARs that can be settled in cash or stock as full value awards
- ISS has added a policy position for voting for nonqualified employee stock purchase plans, requiring four features to be met
- ISS will recommend a withhold vote from compensation committee members if the ISS pay for performance standard is not met unless the committee indicates how it will improve performance
- Case-by-case determination of bundled equity plan amendments
Executive Compensation Disclosure

- Although the disclosure rules have not been amended this year, there is a heightened sensitivity over what should be included and how it should be presented.

- Alan Beller, Director of the Division of Corporate Finance of the SEC, has given speeches this year emphasizing that disclosing all compensation “takes precedence” over the detailed tabular disclosure requirements.

- Section 402(b)(2)(iii)(C) of Regulation S-K requires disclosure of perquisites and other personal benefits, securities or property unless the aggregate amount is less than either $50,000 or 10% of the total annual salary and bonus.

- Each perquisite exceeding 25% of reported perquisites for a named executive officer needs to be disclosed.
Executive Compensation Disclosure

- Perquisites, for example, are coming under greater scrutiny
  - Must be valued at incremental cost
  - Some companies are presenting perquisites as a separate table to provide clearer detail of the components of other annual compensation – see the Honeywell International proxy statement
  - SEC staff has expressed concerned about payments being categorized as business expenses rather than perquisites
  - The Council of Institutional Investors has a policy that “total perquisites should be described, disclosed and valued”

- Other things companies can do to expand compensation disclosure:
  - Expand 162(m) disclosure to specify how much compensation of the named executive officers is non-deductible
  - Specify that all compensation to the named executive officers has been disclosed
Director Compensation Disclosure

- The heightened sensitivity relating to compensation disclosure also applies in the area of director compensation.
- The recent Disney action makes clear that careful attention must be paid to related party transactions that must be disclosed under Item 404 of Regulation S-K, such as employment of adult children or spouses of directors who make over $60,000 per year.
- Director compensation disclosure may need to go beyond traditional director awards of cash and securities to encompass items that could be characterized as perks:
  - Reimbursement of spouse’s airfare to a board meeting
  - Secretarial services
  - Car and driver services
- Consider addressing director stock ownership guidelines in director compensation discussion.
Compensation Committee Report

- Avoid boilerplate
- Include a statement of philosophy
- Discuss relationship of corporate performance to executive compensation
- Useful to include peer company benchmark information
- If the compensation committee has “tallied” all compensation paid to executives consider including a statement to that effect
- State that the compensation committee has reviewed all components of CEO/named executive officer compensation
- Be sure to include specific disclosure concerning how CEO compensation is calculated
- Get “credit” in the compensation committee report by disclosing the absence, where applicable, of categories of compensation and benefits that investors scrutinize
Developments in Executive Compensation

- Changes in best practices
- Shareholder expectations as to executive and director pay levels
- Process of reviewing compensation – selection of peer group and consultant, duty to be informed
- Accounting rule changes
- $1 million limit on deductible compensation

- Nonqualified deferred compensation tax rules
- Stock exchange requirements
- Disclosure of mutual fund proxy votes
- IRS executive compensation audit program
Effect of Developments

- Compensation committee procedures
- Changes in rules
- Deferred compensation rules
- Shareholder approval rules
- Compensation committee report
- Tax audit considerations
- Shareholder considerations