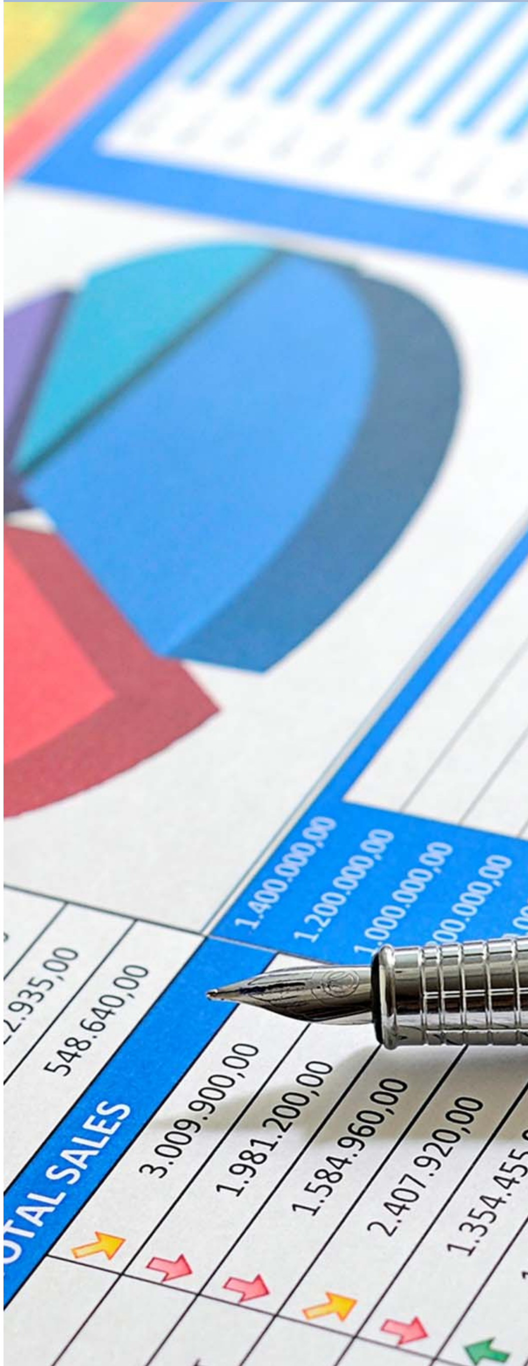

2014 PROXY SEASON UPDATE

Key Considerations for Public Companies

December 10, 2013

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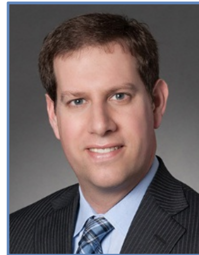

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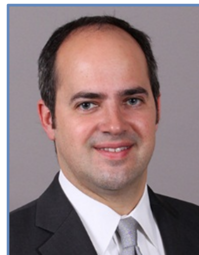

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Compensation Committee and Adviser Independence – NYSE and NASDAQ Rules

- June 20, 2012 - SEC issued final rules to implement Section 952 of Dodd-Frank.
  - Directed securities exchanges to establish listing standards requiring Compensation Committee (CC) members to be independent board members and requiring CCs to have the sole discretion to retain compensation consultants and legal and other advisers.
- September 25, 2012 – NYSE and NASDAQ filed proposed rules with the SEC.
- January 2013 – SEC approved NYSE and NASDAQ listing rules.
- November 26, 2013 – NASDAQ amended its rules on CC Independence.

Compensation Committee Independence – November 26, 2013 NASDAQ amendments

- NASDAQ amendments change CC independence rules:
  - Compensation – Removed "bright-line" prohibition on receipt of any compensatory fees by CC members; board must instead "consider" the source of all compensation accepted by the director, including:
    - consulting, advisory and other compensatory fees paid by company;
    - board or board committee service fees; and
    - retirement compensation (including deferred compensation) for prior service with the company.
  - Affiliate Relationships – Added certain factors that board should consider in evaluating an affiliate relationship.
  - Note: No change to the requirement that CC members be "Independent Directors" within the meaning of NASDAQ Listing Rule 5605(a)(2).

Compensation Committee and Adviser Independence – NYSE and NASDAQ Rules (cont.)

- Timeline for New Rules:
  - NYSE Listed Companies:
    - Have until the earlier of its first annual meeting after January 15, 2014 and October 31, 2014 to comply with the new director independence rules.
    - All other provisions of the new NYSE rules became effective on July 1, 2013.
  - NASDAQ Listed Companies:
    - Already required to comply with the CC authorization and funding requirements.
    - Have until the earlier of its first annual meeting after January 15, 2014 and October 31, 2014 to:
      - establish a formal CC of at least two members with a written charter; and
      - ensure that all CC members meet the enhanced independence tests as revised.

Compensation Committee and Adviser Independence – NYSE and NASDAQ Rules (cont.)

- Compensation Committee Action Items:
  - Brief the CC (and perhaps the full board) on the rule changes.
  - Form a CC if none exists (i.e., NASDAQ companies).
  - Determine whether CC members meet new independence requirements and consider changes to CC composition.
  - Revise D&O questionnaire to reflect new CC member independence requirements.
  - Review CC Charter to determine if changes are needed to:
    - description of scope of the CC's responsibilities; and
    - prohibition on CEO presence during discussion of CEO compensation.
  - Review Corporate Governance Guidelines to determine if changes are needed.

Compensation Committee and Adviser Independence – NYSE and NASDAQ Rules (cont.)

- Compensation Committee Action Items (cont.):
  - NASDAQ Certification – NASDAQ-listed companies must submit a one-time certification to NASDAQ that the company has complied with the requirements relating to CC charter and composition.
    - Due no later than 30 days after the earlier of the company's first annual meeting after January 15, 2014, or October 31, 2014.
    - Certification will be made electronically through NASDAQ's Listing Center: https://listingcenter.nasdaqomx.com.
    - Form of certification will be available no later than January 15, 2014. A draft form of the certification is available at: http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2012/SR-NASDAQ-2012-109_Amendment_1.pdf
    - Note: smaller reporting companies, foreign private issuers, controlled companies and companies relying on a phase-in schedule are required to file the certification even if they are exempt from some or all of NASDAQ's CC requirements.

Proposed Pay Ratio Disclosure

- Dodd-Frank Section 953(b) requires disclosure of:
  - (a) the median of the annual total compensation of all employees of the issuer, excluding the CEO;
  - (b) the annual total compensation of the CEO; and
  - (c) the ratio of (a) to (b).
- Timeline:
  - September 19, 2013 – SEC proposed rules issued.
  - December 2, 2013 – SEC comment period ended.
  - Future?
    - 2014 – Final rules adopted.
    - 2015 – Data for this year required to be compiled.
    - 2016 – Proxy Statements first required to include such disclosure.

Proposed Pay Ratio Disclosure (cont.)

- Flexible approach for identifying the median employee:
  - May select a methodology that is appropriate to the size and structure of the business and the way employees are compensated.
  - Permitted to identify the median employee based on total compensation using either:
    - full employee population; or
    - a statistical sample of that population.
- All employees must be considered:
  - All full-time, part-time, temporary, seasonal and non-U.S. employees;
  - Those employed by the company or any of its subsidiaries.
  - Those employed as of the last day of the company's prior fiscal year.

Proposed Pay Ratio Disclosure (cont.)

- Reasonable estimates permitted when:
  - Calculating the annual total compensation.
  - Calculating any element of total compensation.
  - Determining the annual total compensation of the median employee.
- Disclosure required of:
  - the ratio;
  - the methodology used to identify the median; and
  - any material assumptions, adjustments or estimates used to identify the median or to determine total compensation.
- Optional additional disclosure:
  - narrative discussion; or
  - additional ratios.

Proposed Pay Ratio Disclosure (cont.)

- Disclosure required in:
  - registration statements;
  - proxy and information statements; and
  - annual reports that must already include executive compensation information.
- No disclosure required by:
  - emerging growth companies;
  - smaller reporting companies; or
  - foreign private issuers.
- Transition period for newly public companies

SEC Proxy Disclosure Hot Button Issues

- Executive Compensation
  - Enhanced disclosure identifying whether and to what extent the company's performance meets the performance objectives underlying performance stock unit grants to certain executive officers.
  - Compensation attributable to multiple positions by one individual.
  - Disclosure regarding factors considered by compensation committee with respect to significant year-over-year increase in awards.
  - Disclosure regarding methodology used by compensation committee in determining long-term incentive equity awards for each named executive.
  - Reconcile disclosure that bonus awards decided on a discretionary basis with disclosure that the issuer had achieved certain performance objectives.
  - Disclosure of determination of option awards size to each named officer in light of significant variation from year-to-year and executive to executive.

SEC Proxy Disclosure Hot Button Issues (cont.)

- DEALINGS WITH SYRIA, SUDAN AND CUBA:
  - Request for detailed disclosure about nature and extent of contacts with those countries noting that many principal customers operate in these jurisdictions and that these countries are designated a state sponsor of terrorism by the U.S. Department of State.
  - Disclose whether such contacts constitute material investment risks both from quantitative and qualitative perspectives.
- SIGNATURE BLOCKS:
  - Second half of 10-K signature page should include signatures of principal executive officer, CFO and controller or principal accounting officer.
- DESCRIPTION OF BUSINESS

Update on Implementation of Dodd-Frank Rules by SEC

- Since Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in July 2010, the Securities and Exchange Commission ("SEC") has proposed and implemented rules as directed thereunder. Under Dodd-Frank, the SEC has 95 such rulemaking requirements: as of the today, approximately 35 have been finalized, 42 have been proposed (40 of which have past-due deadlines), and 18 are in the pre-proposal stage (8 of which have past-due deadlines).

Update on Implementation of Dodd-Frank Rules by SEC (cont.)

- PRE-PROPOSAL STAGE
  - Modernize beneficial ownership reporting. 13G/D reporting, solicit comments on disclosure obligations relating to equity swaps and other derivative instruments, short sales and filing deadlines.
  - Standard of conduct regarding personalized investment advice
  - "Clawback" provisions – directing securities exchanges to prohibit listing of securities of issuers that have not developed and implemented compensation clawback policies.
- PROPOSED RULES
  - Standards for assessing diversity policies and practices of regulated entities.
  - Disclosure of pay ratios.
  - Prohibition of proprietary trading and certain relationships with hedge funds and private equity funds.
  - Disclosure of incentive-based compensation agreements at financial institutions.

Update on Implementation of Dodd-Frank Rules by SEC (cont.)

- ADOPTED RULES:
  - Required due diligence for delivery of dividend, interest and other valuable property to missing securities holders.
  - Listing standards concerning compensation committees.
  - "Conflict minerals" disclosure. On August 22, 2012, the SEC adopted a rule requiring companies to publicly disclose any use of certain conflict minerals that originated in the Democratic Republic of the Congo or adjoining countries, if any such minerals are "necessary to the functionality or production of a product" manufactured by those companies. In October 2012, the National Association of Manufacturers, the Chamber of Commerce of the United States of America, and the Business Roundtable brought suit in the District Court in the District of Columbia, contesting the validity of the SEC rule. The District Court ruled in favor of the defendant SEC and against the plaintiffs' contention that the disclosure scheme transgressed the First Amendment. The plaintiffs filed a notice of appeal on August 12, 2013. The appeal is ongoing.

Update on Implementation of Dodd-Frank Rules by SEC (cont.)

- **Payment disclosures by resource extraction issuers (*adopted* August 22, 2012, *vacated* July 2, 2013)**
- Summary: On August 22, 2012, the SEC adopted a rule requiring resource extraction issuers engaged in the development of oil, natural gas or minerals to annually disclose certain payments made to the US government or foreign governments on a new Form SD.
- Update: The rule became effective November 13, 2012. Issuers were supposed to comply from and for fiscal years ending after September 30, 2013. In October 2012, the American Petroleum Institute, the Independent Petroleum Association of America, the National Foreign Trade Council, and the US Chamber of Commerce brought suit in the District Court of the District of Columbia, contesting the validity of the SEC rule. In July 2013, the District Court ruled against the SEC and held it erred in its interpretation of the Dodd- Frank Act by mandating public disclosure of the reports, and failed to properly consider exemption requests. The Court vacated the rule and remanded the rule back to the SEC. The SEC has indicated that it will not appeal the decision, but rather will redevelop the rule in conformity with the ruling in the district court case. The SEC has not provided a timetable for the proposal of the new rule.

Update on Implementation of Dodd-Frank Rules by SEC (cont.)

- Whistleblower incentive program.
- Say on pay and golden parachute compensation.
- Elimination of broker discretionary voting on executive compensation matters.

Strategically Preparing for Your Pre-Proxy-Filing Board & Committee Meetings: Gathering Your Data

- Re-Reading 2013 ISS & Glass Lewis Reports
  - Positive recommendations expressed “with concern”/warnings.
  - Factual errors to correct without proxy season pressure?
- Any 25%+ Votes to be Addressed for Glass Lewis?
- Any Red Zone/Failed SOP Votes to Discuss with ISS?
- Any Passed Shareholder Proposals?
  - New ISS policy: one year of majority of votes cast on shareholder proposals requires board “action”, or else ISS will generally recommend AGAINST/WITHHOLD for entire board (except new nominees).
    - However, under updated policies, will consider on a “case by case” basis.

Strategically Preparing for Your Pre-Proxy-Filing Board & Committee Meetings: Gathering Your Data

- Early Pay-for-Performance Analytics Analysis from ISS?
  - Anything other than “Low” Concerns?
  - Remember to repeat, as peer + your updated data are added to models.
- Feedback from Proxy- + Off-Season Outreach to “Governance/Proxy Voting Side” of Investors
  - Make sure that “drafters” review/understand feedback!
- Analysis of any Off-Season Internal Governance Audits – to early ID potential areas of vulnerability

Strategically Preparing for Your Pre-Proxy-Filing Board & Committee Meetings: Gathering Your Data

- Any Letters Received from Investors or 3rd parties, e.g., Vanguard, CII or 30% Coalition?
  - Respond!
- Any New Industry-Specific Issues?
- ISS Updates – a few for 2/1/14, with more to come year-round now
- Glass Lewis Updates expected any day
- Peer Updates – if any changes since 2013 disclosure
  - ISS's window closed yesterday
  - Can still update for Glass Lewis on Equilar's web site through year-end at http://insight.equilar.com/app/peer_update/

Strategically Preparing for Your Pre-Proxy-Filing Board & Committee Meetings: Year-End Decisions

- Make Recommendations to Key Committees/Full Board
  - Those that will result in decisions that will show up:
    1. In proxy statement disclosure for 2014
    2. Possibly in earlier investor discussions
  - Those that may result in withdrawn shareholder proposals
  - Responsive to feedback and consistent with company values + board fiduciary duties – can be a “Balancing Act”
- Analysis for New Standards for Independence of Compensation Committee Advisors – start early to consider upon whose advice Committees are relying?
  - Not only compensation consultants, depending on facts
  - Consider law firms and proxy solicitors
  - Consider consulting advice received from ISS and Equilar

Other Pre-Season Preparation

- Update Data in ISS's QuickScore System
  - Still uncertain relationship to recommendations
  - Can still be a way, along with governance profile pages, for their clients to gather key information on you
  - Should you care? -- Consider at least annual check of your data in their system …
- Initial Proxy Statement Drafting to Incorporate Past Year of Feedback
  - Makes for much more readable document for "key readers"
  - Start early if "revamping" or telling a "challenging story" is your goal

Rethinking Required + Not Required Disclosures:
Sampling of Going Beyond Legally Required to More Effective

- Overall Good Proxy Statements: Large Cap – Allstate, Best Buy, Coca-Cola, GE, Hartford Financial Services, Honeywell, McDonald's, Pfizer, Prudential
- Overall Good Proxy Statements: Small Cap – H&R Block, Krispy Kreme Doughnuts, Pepco Holdings, Saks
- Summary Proxy Statements – Agilent, Chesapeake Energy, GE, Honeywell, McDonald's, Pitney Bowes, Prudential
- Special Letter to Shareholders in New/Challenging Situations, or Just Good Governance: Allstate, Barrick Gold, Best Buy, Goldman Sachs, Mondelez, Prudential, Sempra Energy, Western Union
- Director Bios, Qualifications and Matrices – Coca-Cola, Goldman Sachs, H&R Block, Kraft Foods Group, Prudential
- Board Committee Tables: Ashland, The New York Times Company
- CEO/NEO Changes: Best Buy, Green Mountain Coffee, Molicorp, Pall, Radisys

Rethinking Required + Not Required Disclosures:
Sampling of Going Beyond Legally Required to More Effective

- Good Ties to Performance to Set Up SOP Votes: Coca-Cola, McDonald's, Prudential
- Good Use of Graphics: Agilent, Coca-Cola, General Mills, Honeywell, Jack in the Box, McDonald's, Prudential, Walgreens, Whirlpool
- Checklist of Which Compensation Practices They Do and Don't Engage in – Coca-Cola, H&R Block, McDonald's, Time Warner
- Responses to SOP Advisory Votes from Prior Year(s)
  - Failed Votes – Actuant, Best Buy, Citigroup, Mylan, Pitney Bowes
  - Red Zone Votes – Dun & Bradstreet, Disney, Hain Celestial
  - High Votes -- FMC Corp, PVH Corp, Rite-Aid, Symantec, Walgreens

Rethinking Required + Not Required Disclosures:
Sampling of Going Beyond Legally Required to More Effective

- Managing/Mitigating Comp Risk – Coca-Cola, Hospira, Thor Industries
- Non-Use of Comp Consultants – Bridgford Foods Corporation
- Understanding How Voting Works – Conoco Phillips, Kraft Foods Group
- Peer Group Selections
  - Changing Peers – Becton Dickinson, CareFusion, Tutor Perini
  - Explaining Selections – Agilent, Deere, McDonald's, Medtronic, Microsoft, Tennant, UnitedHealth Group
  - Explaining Lack of Comparable Peers – Carnival, FLIR Systems, Piper Jaffray

Proxy Advisory Firm Policy Updates: ISS

- Responsiveness to Majority Votes on Shareholder Resolutions and Failed Director Elections
  - Clarified 2013 Update, to provide ISS analysts with more discretion, on a case-by-case basis, with clues given in other ISS policies and FAQs:
    - Factors for Majority-Supported Shareholder Resolutions:
      i. Disclosed outreach efforts by boards to shareholders after the vote
      ii. Rationale disclosed in proxy statement for level of implementation
      iii. Subject matter of proposal
      iv. Level of support for + opposition to resolution in past meetings
      v. Board actions taken in response to vote and shareholder engagement
      vi. Continuation of underlying issue as voting item on the ballot (either by management or shareholder proposals)
      vii. Other factors as appropriate
    - Factors for Failed Director Elections: Whether company has addressed issue(s) that caused failed election

Proxy Advisory Firm Policy Updates: ISS

- Pay-for-Performance Metric Adjustments: RDA (Relative Degree of Alignment) now only relative comparison to peers on a 3-year basis
- Lobbying Proposals – Revised factors on case-by-case analysis:
  - Public disclosure regarding trade associations that it supports/is a member of, and lobbying conducted by such associations
  - Public disclosure of lobbying policies and oversight mechanisms
    - Added management oversight to that of Board
  - Any significant controversies, fines or litigation regarding such lobbying
- Human Rights Assessment Disclosure Proposals – similar to lobbying analysis (focus on disclosure + oversight), but added:
  - Whether proposal is "unduly burdensome or overly prescriptive"

Proxy Advisory Firm Policy Updates: ISS

- New Benchmark Policy Consultation Period Until February 2014 – requesting feedback on specific policies, as part of new, ongoing consultation period, which could become a year-round phenomenon:
  - Director Tenure – impact on independence + right mix of director tenures
  - Director Independence – more case-by-base analysis, focusing on former CEOs, familial + professional relationships
  - Audit Firm Tenure – whether it should be factor in auditor ratification analysis
  - Independent Chairs – examining new approaches, with still some case-by-case analysis
  - Equity Plan Scoring – whether a more holistic approach with company-specific consideration vs. current more stringent focus on burn rate + SVT

Shareholder Activism and "Hot" Shareholder Proposals for 2014

- <u>Political Contributions and Lobbying</u> – biggest in ESG category, though still not all that important to mainstream investors (averaging 24-32%, with 3 passing + others negotiated away), *but did not fade as issue in a non-national election year*
  - Still good to engage on these issues, with ISS (with its updated lobbying policy) seeming to focus a lot on *written* disclosure surrounding:
    - Board/management oversight
    - Who really makes decisions on amounts + recipients
    - Trade association disclosures + % dues used for which, if any, types of lobbying
  - If in top 200 of S&P 500, check where you stand and what your peers are doing in the latest 2013 CPA-Zicklin Index (**politicalaccountability.net**)
  - Will Qualcomm-type litigation continue (using books + records) to force disclosure?
- <u>Board Declassification</u> – largely successful Harvard Shareholder Rights Project
  - At least 27/30 passed in 2013 + average support of approximately 80%
  - Already submitted 31 proposals to S&P 500 and Fortune 500 companies for 2014, with 7 of those already agreeing to bring management proposals

Shareholder Activism and "Hot" Shareholder Proposals for 2014

- Independent Chair – at least 79 proposals (32% average; down from 35% in 2012) and 6 passed
- Repeal Supermajority Vote Requirements – at least 48 proposals with at least 13/17 passing (71.7% average)
  - Difficult to negotiate away
- Majority Voting for Director Proposals – about 16/31 passing with average 58% vote, *but much more action behind the scenes!*
  - Having impact ("teeth") beyond proposals in adopting any form – barely passing (50's) led to resignations at HP + JP Morgan, as more companies voluntarily adopt some form and directors may be having reputational concerns

Shareholder Activism and "Hot" Shareholder Proposals for 2014

- Other ESG Proposals – *What Else?*
  - Board Diversity lead by 30% Coalition, which coordinated several (with average of 28-35% support, *depending on universe + calculator*), though many withdrawn (by (i) discussing searches generally and/or (ii) adding language to governing documents about commitment), but one at CF Industries passed
  - Environmental Sustainability – (28-33% average vote, 1 passed), with most common:
    1. Climate change/sustainability – almost 50% of those submitted
    2. Energy efficiency/recycling - about 14% of those submitted
    3. Energy extraction-related risks – about 12% of those submitted

    - Note: "Carbon Asset Risk" Initiative to 45 top energy companies worldwide, coordinated by 70 global investors, with aim to reduce GHG emissions by 80% by 2050,increased disclosure regarding board oversight + ongoing dialogue
  - Often negotiated away, through disclosure + constructive engagement

Shareholder Activism and "Hot" Shareholder Proposals for 2014

- Compensation Proposals – about 100 proposals in 2013, up *A LOT* from 61 in 2012 + 39 in 2011, with shift toward even more progressive policies
  - Most popular were:
    (A) equity retention – average 24.2% vote
    (B) pro-rata vesting of equity awards, rather than acceleration, upon a CIC – average 33.4%)
  - Average vote was about 39%, 1 passed (clawback at McKesson)
  - Plus several withdrawn, as companies considered how far to go
- Right To Call Special Meetings and to Act by Written Consent – a few continue to pass with average votes in low 40s% (down from mid-40s in prior years), but:
  - Different ways to handle, given ISS and SEC policies
  - Very different impact for companies, if ever adopted + used by investors

Expectations for Proxy Access

- Shareholder Proposals
  - Still in early stages, as fewer proposals submitted than in 2012, but a greater percentage went to a vote, as shareholders learned how to avoid no-action exclusions
  - Vote averaged about 32%, with more success with non-binding 3-year/3% threshold, + 5 passing (Verizon Communications, Nabors Industries, CenturyLink, Darden Restaurants and micro-cap Advanced Phoenix)
  - Expect 2014 targets to still easy ones, with same thresholds
  - To be safe on case-by-case ISS analysis, companies should understand their compliance with highest governance standards (including transparency of disclosure) + watch performance
- Actual Proxy Access Nominees: Query whether we'll see any Proxy Access nominees at HP and Western Union in 2014?

Attacks on Proxy Compensation Disclosure

- Post-negative say on pay stockholder derivative cases
- Pre-vote challenges
  - Say-on-pay disclosures
  - Equity plan disclosures
- IRC 162(m)

Post-negative Say-on-Pay Stockholder Derivative Cases

- Theory that board breached its fiduciary duty and/or committed waste by not rescinding pay to executives after negative shareholder advisory vote on pay
- Almost uniformly dismissed
- Not being brought anymore
- No real developments this year
  - Charter Township of Clinton Police and Fire Retirement System v. Martin, 219 Cal.App.4th 924, 162 Cal.Rptr.3d 300 (September 17, 2013)

Pre-vote Say-on-Pay Challenges

- Theory that proxy fails to disclose sufficient information regarding executive compensation for shareholders to cast an informed say-on-pay vote
- Enjoin annual meeting and vote until additional disclosure (more and why)
  - 8 investigation notices but only a couple lawsuits (Apple and Consolidated Edison) in 2013
    - Both lawsuits were not pure say-on-pay lawsuits

Pre-vote Say-on-Pay Challenges (cont.)

- Pure say-on-pay cases have been unsuccessful at preliminary injunction stage
  - See, e.g., AAR (October 9, 2012); Symantec (October 17, 2012); Apple (February 22, 2013); Hain Celestial (November 14, 2012)
- Pure say-on-pay cases have also not survived motions to dismiss
  - See, e.g., AAR (April 3, 2013); Symantec (February 2, 2013 and August 2, 2013); Hain Celestial (June 20, 2013)

Pre-vote Share Issuance Challenges

- Theory that proxy does not disclose enough information for stockholders to determine whether to increase number of shares available for issuance under equity incentive plan
- Enjoin annual meeting and vote until additional disclosure
  - Dilutive impact of issuing shares
  - Burn rate and overhang analysis
  - How determined number of shares requested
  - Projected grants under consideration
  - Potential equity value or cost of the additional shares
  - Fair summary of any expert analysis

Pre-vote Share Issuance Challenges (cont.)

- Over 72 investigation notices and at least 5 lawsuits in 2013
  - Knee v. Brocade Communications Systems, Inc. (Santa Clara County Superior Court): Meeting enjoined (April 10, 2012); settled for $625,000 in fees
  - Martha Stewart; WebMD; H&R Block; PriceSmart; Immunocellular; Applied Minerals; Consolidated Edison: Additional disclosures and settled for between $60,000 and $300,000 in fees
  - Some companies may have reached resolutions without court proceedings

Pre-vote Share Issuance Challenges (cont.)

- Most preliminary injunction motions denied
  - Clorox (November 12, 2012); Plantronics (August 1, 2012)) ; Ultratech (July 16, 2012); Symantec (October 17, 2012); Hain Celestial (November 14, 2012)
  - Microsoft
    - Obtained declaration from CalSTRS indicating disclosures sufficient
- Motions to dismiss granted
  - Hain Celestial (June 20, 2013)
- Motion for summary judgment denied
  - Clorox (June 25, 2013)

Pre-vote Share Issuance Challenges (cont.)

- Judgment granted
  - Clorox (August 21, 2013)
    - Additional information plaintiff requested was not material

IRC 162(m)

- Imposes a corporate deduction limit of $1M annually on compensation paid to named executive officers listed in the proxy, but allows exemptions to the deduction limit for "qualified performance-based compensation" provided that shareholders have approved the plan pursuant to which the performance-based compensation is paid
- 162(m) Plans are plans implemented to take advantage of the performance-based exemptions
- Over 50 investigation notices and at least 10 lawsuits in 2013

IRC 162(m) (cont.)

- Shareholders have sued alleging waste and unjust enrichment if companies did not have a 162(m) plan in place when shares granted (thereby giving up an opportunity to reduce company's tax burden).
  - Delaware Chancery Court and Delaware Supreme Court have generally rejected claims based on this theory. See *Freedman v. Adams* (XTO Energy Inc.), No. 4199, 2012 WL 1345638 (Del. Ch. Mar. 30, 2012) aff'd by 58 A.3d 414 (Del. Jan. 14, 2013); see also *Seinfeld v. Slager* (Republic Services, Inc.), No. 6462, 2012 WL 2501105 (Del. Ch. Jun. 29, 2012) (dismissing all claims except those concerning directors' grants to themselves where stock plan put no real bounds on board's ability to set its own stock awards).
  - United States District Court for the District of Delaware has been more accommodating to plaintiffs on this issue. *Resnik v. Woertz* (Archer-Daniels-Midland Company), 774 F. Supp. 2d 614 (D. Del. Mar. 28, 2011). Case recently settled with agreed limits on maximum size of grants and attorneys' fees up to $1.5 million.

IRC 162(m) (cont.)

- Shareholders have also sued alleging that company's disclosures were misleading with respect to operation of equity incentive plans intended to comply with 162(m) (and so 162(m) plans were not effective).
  - Delaware Chancery Court rejected this claim in *Freedman v. Adams* (XTO Energy Inc.), No. 4199, 2012 WL 1345638 (Del. Ch. Mar. 30, 2012) aff'd by 58 A.3d 4*14* (Del. Jan. 14, 2013) but Delaware Supreme Court did not address.
  - United States District Court for the District of Delaware
    - It has rejected some of these claims. See, e.g., *Abrams v. Wainscott* (AK Steel Holding Corp.), No. 11-297, 2012 WL 3614638 (D. Del. Aug. 1, 2012); *Seinfeld v. O'Connor* (Republic Services, Inc.), 774 F. Supp. 2d 660 (D. Del. Mar. 30, 2011).
      - AK Steel case is particularly interesting because amended to assert a coercion claim that was also rejected. Abrams v. Wainscott, No. 11-297, 2013 WL 6021953 (D. Del. Nov. 13, 2013).
    - Others have been allowed to proceed. See *Hoch v. Alexander* (Qualcomm), No. 11-217, 2011 WL 2633722 (D. Del. July 1, 2011); Hoch v. Alexander, No. 11-217, 2013 WL 3353891 (D. Del. July 2, 2013).
      - Qualcomm even got opinion from IRS in form of Issue Resolution Agreement that plan complied with 162(m) but court findings not conclusively binding on IRS.

IRC 162(m) (cont.)

- Failure to get renewed approval of plans under 162(m)
  - Regulations under 162(m) require company to get re-approval of performance goals in equity incentive plan every five years (except in certain limited circumstances)
  - Some companies have failed at this corporate housekeeping and have been sued
    - New Jersey Resources Corporation issued a supplemental proxy to provide for shareholder vote
      - "Agreement in principle" for plaintiff to dismiss in return for the supplemental proxy and attorneys' fees of $135,000
    - Dow Chemical Company (filed on March 5, 2013 in D. Del.)
      - Case is ongoing

IRC 162(m) (cont.)

- Grant of shares in excess of individual sub-limits in plan
  - Companies include limits on the number of shares that can be granted to an individual under an equity incentive plan in order to comply with certain regulations under 162(m)
    - Companies, however, also usually retain discretion to grant additional shares that would not be tax deductible
      - Some companies' equity incentive plans make it clear that the limits on individual grants set forth in the plan are solely for purposes of deductibility exception under 162(m) and some do not
      - Company proxies also vary in how explicit they are that the company can issue shares to an individual in excess of the limits set forth in the equity incentive plans
        - Only "repercussion" being that some of the value of the grant will not be tax deductible
  - Most of the recent cases have asserted this claim along with a claim that disclosures are inaccurate by claiming that grants (or some of them) are tax-deductible
  - Some of these lawsuits assert derivative claims for waste and unjust enrichment and direct claims seeking to enjoin annual meeting based on the theory that the descriptions of past grants to executives seem to suggest that all grants were tax deductible when they were not

IRC 162(m) (cont.)

- Grant of shares in excess of individual sub-limits in plan (cont'd)
  - Board clearly violated an unambiguous provision of stock plan excuses demand and states a claim. See, e.g., Pfeiffer v. Leedle (Healthways), No. 7831, 2013 WL 5988416 (Del. Ch. November 8, 2013).
    - Presumably for same reason, some companies that were sued rescinded "excess" grants, issued supplemental disclosures and cases have settled or plaintiffs have moved for mootness fees
      - DeVry; Echostar; AmerisourceBergen; Diodes; Stillwater Mining; Alphatec
  - Where plan has better language (presumably), companies are fighting or issuing additional disclosures to avoid injunction fight and then moving to dismiss
    - Mindspeed; Simon Property Group; Honeywell; EnerNOC

IRC 162(m) (cont.)

- What's old is new again
  - Peregrine
    - Grants in excess of sub-limits in 162(m) plan and spring loading

How to Reduce the Likelihood of Being Sued and Increase the Likelihood of Prevailing in any Subsequent Litigation

- Create a process and build a record that will support the directors' ability to meet their fiduciary duties
  - Board and Compensation Committee materials should:
    - be distributed well in advance of meetings; and
    - contain all information necessary to make informed decisions
  - Adequate time should be reserved for discussions with advisors and among Board members
- Minutes should be prepared with a view towards subsequent proxy disclosures and potential litigation
- Advise Compensation Committee of the litigation risk

How to Reduce the Likelihood of Being Sued and Increase the Likelihood of Prevailing in any Subsequent Litigation (cont.)

- Prepare the proxy statement with potential litigation in mind
  - Know which disclosures are likely to raise issues
  - Go beyond the requirements of Items 402 and 407 of Regulation S-K to ensure adequate disclosure
  - Provide reasons why changes in executive compensation were made
  - Take a reasoned approach to providing additional disclosure – providing disclosure that is not material may raise more questions than answers and thus raise your litigation risk
  - Consider retaining outside counsel who have defended these cases to review draft disclosures

How to Reduce the Likelihood of Being Sued and Increase the Likelihood of Prevailing in any Subsequent Litigation (cont.)

- In connection with executive compensation (say-on-pay) votes, consider:
  - Including in the CD&A, the reasons the company selected:
    - its compensation consultant;
    - the particular mix of salary, cash incentive compensation and long-term incentive compensation; and
    - particular companies as peers for purposes of benchmarking compensation.
  - Not including in the CD&A:
    - Details concerning the compensation consultant analyses provided to the company's board of directors

How to Reduce the Likelihood of Being Sued and Increase the Likelihood of Prevailing in any Subsequent Litigation (cont.)

- In connection with votes to increase the number of shares authorized, or available for issuance under equity plans, consider disclosing:
  - The reasons that the company determined to increase the number of shares at this time
  - How the company determined the number of additional shares requested to be authorized, including burn rates
  - The potential equity value and/or cost of the authorization of additional shares
  - The potential dilutive impact of the authorization of the additional shares
  - More disclosure here is generally better; consider exceeding the requirements of Item 10 of Schedule 14A
- Carefully consider timing of submission of equity plans for shareholder approval

How to Reduce the Likelihood of Being Sued and Increase the Likelihood of Prevailing in any Subsequent Litigation (cont.)

- After the annual meeting has occurred:
  - Watch the shares available and do not grant shares in excess of the authorized amount
  - When hiring new executives, make sure grants do not exceed the number permitted to be issued to executives during a calendar or fiscal year
  - If executives and directors are required to hold a certain minimum number of shares under stock ownership guidelines, confirm that they do not fall below the minimum levels
  - If the performance-based goals in your plan need to be reapproved by shareholders every 5 years under Section162(m), make sure the plan is put up for a vote accordingly

SEC Accounting Comments

Ranking Twelve months ended 30 June			as % of total Registrants that received comment letters
Comment area	2013	2012	2012 and 2013
Management's discussion and analysis	1	1	51%
Fair value measurements	2	2	25%
Non-GAAP financial measures	3	8	16%
Contingencies and commitments	4	4	19%
Revenue recognition	5	6	17%
Income taxes	6	5	17%
Signatures, exhibits and agreements	7	3	20%
Intangible assets and goodwill	8	10	14%
Segment reporting	9	9	15%
Executive compensation disclosures	10	7	15%

SEC Accounting Comments (cont.)

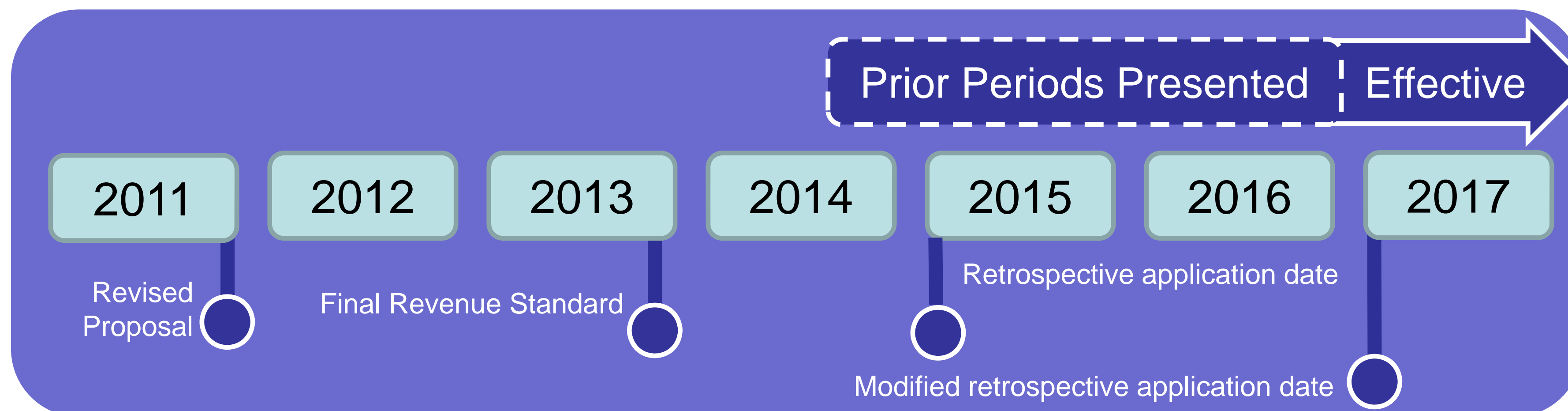
- Current topics
  - New fair value disclosures under ASU 2011-04
  - Rule 3-10 of regulation 3-10 requiring presentation of guarantor/non guarantor condensed consolidating information for subsidiaries guarantor or issuer
  - Materiality – “little r” restatements (not requiring to file an item 4.02 Form 8-K, *Non reliance on previously issued financial statements*)
  - Internal Control over Financial Reporting (ICFR)
- Expected future areas
  - Valuation of equity securities issued shortly before an IPO
  - New presentation and disclosure requirements in ASU 2013-12 to reclassify amounts out of accumulated other comprehensive income
  - Disclosures about the anticipated effect of new accounting standard (e.g., new revenue recognition standard) as required by SAB Topic 11-M

Recent Accounting Developments

- New standards
  - Investment companies accounting and disclosures
  - Reporting amounts reclassified out of accumulated other comprehensive income
  - Balance sheet offsetting disclosures
  - Indefinite-lived intangible assets impairment assessment
  - Liquidation basis of accounting
  - Joint and several liabilities
  - Release of cumulative translation adjustment (CTA)
  - Presentation of unrecognized tax benefits
  - Federal funds effective swap rate may be designated as a new benchmark for hedge accounting purposes

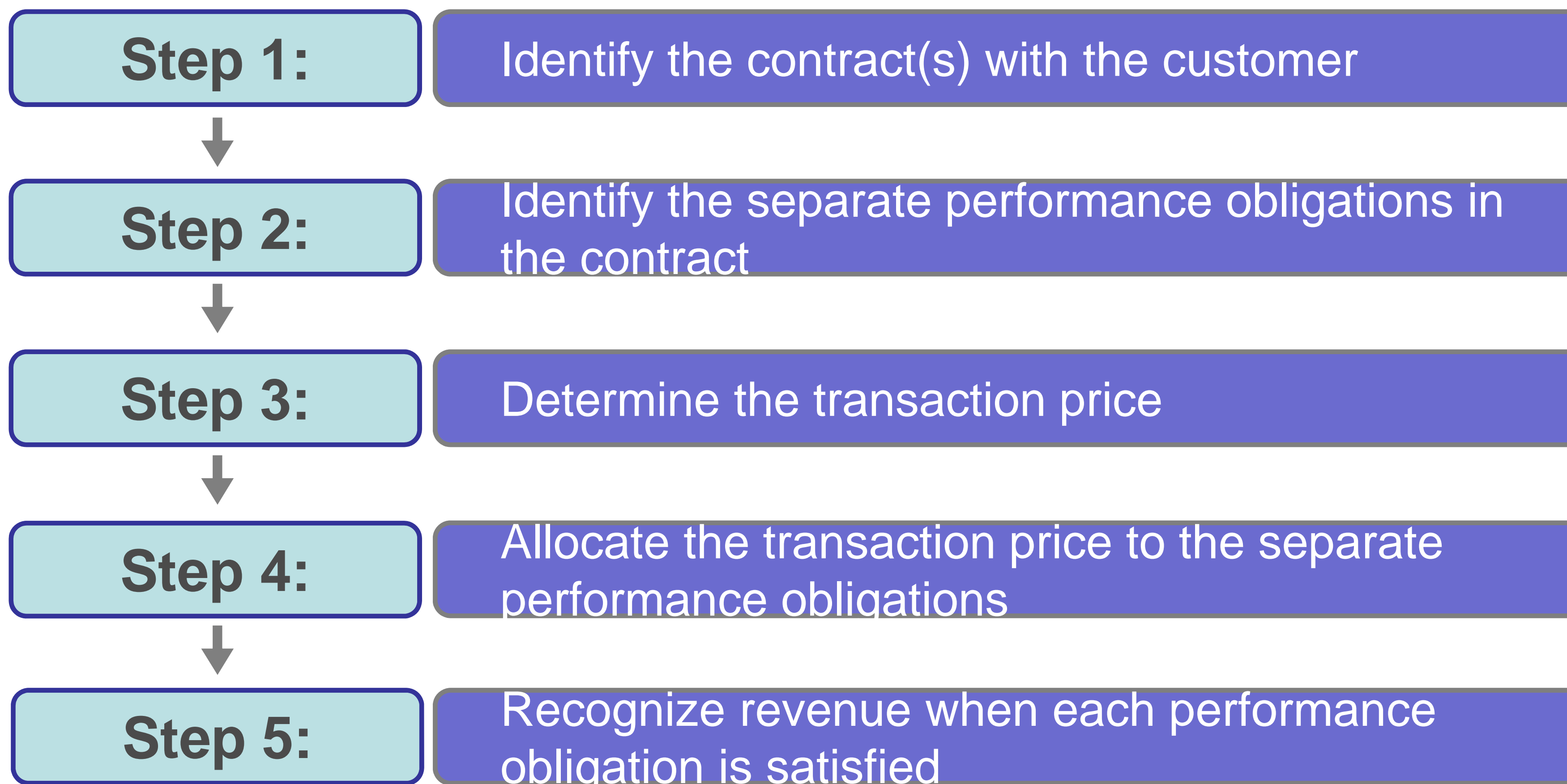
New Revenue Recognition Standard Overview

- Latest ED issues November 2011
- Comment period on ED ended 13 March 2012
- Final standard expected in late 2013
- Standard will be effective for annual periods beginning on or after December 15, 2016
- Boards agreed to allow either retrospective application or a modified retrospective
- Early adoption only allowed by IASB

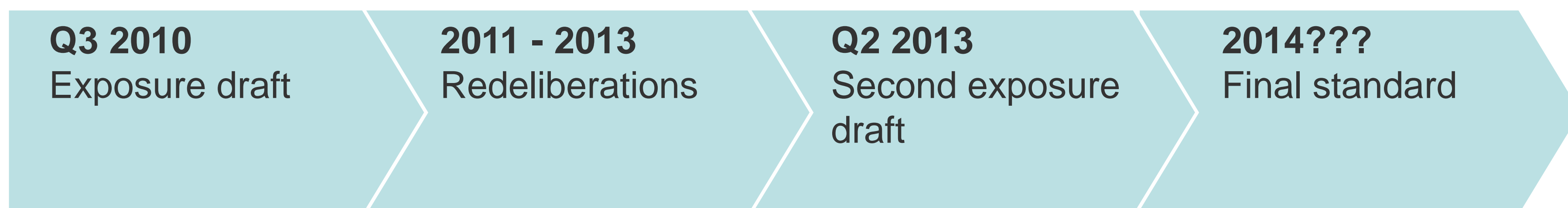


New Revenue Recognition Standard Overview Summary of the Model

- **Core principle**—Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity *expects to be entitled in exchange for those goods or services*



New Lease Standard Overview



- Lessees would recognize most leases on balance sheet
- Lessees and lessors would classify leases based on the lessee's expected consumption of the underlying asset
- Classification would determine the pattern of lease expense and lease revenue recognition
- Effective date not yet determined
- Comment letter period ended September 13th 2013

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