TONKON TORP LLP
ATTORNEYS

CLIENT UPDATE

CORPORATE FINANCE

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Preparing for the 2012 Proxy Season

This Client Update provides an overview of corporate governance and disclosure matters that U.S. public companies should note as they approach the 2012 proxy season. The matters addressed will not apply equally to all companies, and their applicability may vary depending on a particular company's size, shareholder base, 2011 voting results, and executive compensation plans and policies.

Proxy Access and Private Ordering

On July 22, 2011, the U.S. Court of Appeals for the D.C. Circuit vacated Rule 14a-11 under the Securities Exchange Act of 1934, the controversial proxy access rule that would have permitted the inclusion of shareholder nominees in company proxy statements. Despite the Court's decision to vacate Rule 14a-11, an amendment to Rule 14a-8 adopted at the same time as Rule 14a-11 allowing shareholders to submit proxy access proposals was not challenged and became effective on September 20, 2011. The amendments to Rule 14a-8 prevent companies from excluding from their proxy materials shareholder proposals seeking to establish individual, company-specific procedures for the nomination of directors by shareholders, a process sometimes referred to as "private ordering."

This means that, although U.S. public companies will not be subject to a mandatory, uniform proxy access standard, they will be required to include in their proxy materials, under certain circumstances, issuer-specific proxy access proposals submitted by shareholders. Commentators anticipate a modest number of shareholder proposals in this area in 2012, as was the case over the past decade with respect to majority voting, staggered boards, shareholder rights to call special meetings and other governance matters.

Say-on-Pay

The 2011 Experience. In 2011, the vast majority of companies chose to conduct say-on-pay votes on an annual basis, and approximately 98% of companies subject to say-on-pay in 2011 received approval of their compensation packages, with an average approval rate of 92% of votes cast. Approximately 40 companies failed to get majority support for their executive compensation programs in 2011. The 2012 proxy season will be the second year of required say-on-pay votes for most U.S. public companies. (Smaller reporting companies are not required to conduct say-on-pay and frequency votes until annual meetings occurring on or after January 21, 2013.)

Companies that held their first say-on-pay vote in 2011 will be required to disclose for the first time in the Compensation Discussion and Analysis section of their 2012 proxy statements "[w]hether and, if so, how the registrant has considered the results of the most recent shareholder advisory vote on executive compensation required by [the SEC's proxy rules] in determining compensation policies and decisions and, if so, how that consideration has affected the registrant's executive compensation decisions and policies." *See* Item 402(b)(1)(vii) of Regulation S-K. Companies may wish to address this requirement in the CD&A by noting the affirmative vote received and disclosing any specific actions taken as a result.

Several lawsuits have been filed against companies after failed 2011 say-on-pay votes alleging that the pay practices which failed to receive majority support were the result of breaches of fiduciary duties or corporate waste by the companies' directors. A number of these cases have been dismissed, and most courts that have reviewed such claims have been highly skeptical of their merits. Nonetheless, a negative say-on-pay vote may present an increased risk of shareholder litigation, particularly if a company is not able to demonstrate that pay packages approved for named executive officers are consistent with the company's articulated performance philosophy. Companies and their consultants should also be careful to document their thorough and well-informed decision making with respect to executive compensation matters.

Proactive Engagement. In connection with required say-on-pay votes in 2011, many companies increased their level of engagement with shareholders, made changes to compensation policies and practices and improved executive compensation disclosure in their proxy statements, including providing new (voluntary) CD&A executive summaries and proxy statement summaries. Executive summaries frequently included charts and graphs that supported executive compensation decisions by specific references to company performance. Companies that included these CD&A summaries in 2011, such as General Electric and Prudential Financial, received positive feedback from corporate governance commentators.

Another tool used by some companies were supplemental proxy soliciting materials, generally in the form of letters to shareholders from the Chairman or CEO highlighting key points shareholders should focus on in making a voting decision. The use of these supplemental materials recognizes the need to communicate the company's position clearly and concisely in the context of the increased length and complexity of the CD&A. Such letters may be particularly useful if certain of a company's pay practices may be viewed as problematic. If used, supplemental soliciting materials are required to be filed with the SEC.

Companies that are not yet subject to the say-on-pay and frequency rules may want to evaluate their compensation plans and decisions at the outset of fiscal 2012 to prepare for the first required vote in 2013. By eliminating problematic pay practices (e.g., tax gross-ups) and ensuring that compensation plans and policies motivate employees in a balanced way and make company objectives a key driver of compensation, companies will be better positioned to receive positive recommendations from ISS and other proxy advisory firms in connection with future votes.

Directors should also familiarize themselves with ISS voting guidelines as they may apply to their company. While such guidelines should never substitute for the directors' exercise of their business judgment based on the circumstances at hand, it may be preferable to evaluate compensation plans and decisions in light of such guidelines in order to avoid a negative voting recommendation from ISS.

Institutional Shareholder Services 2012 Proxy Policies

ISS released its annual update to its proxy voting guidelines for the 2012 proxy season on November 17, 2011. The updates will apply to shareholder meetings held on or after February 1, 2012. The update changes ISS proxy recommendations in several areas, including:

- <u>Determining the alignment of CEO pay with company performance</u>. ISS has adopted a new methodology for analyzing pay-for-performance that is meant to provide a more complete view of the relationship between executive pay and company performance over a longer period of time. ISS will consider:
    - The alignment between the company's total stockholder return

("TSR") rank and the CEO's total pay rank within a peer group, as measured over one and three years;

  - The multiple of CEO total pay relative to the peer group median; and

  - The alignment between CEO pay and a company's TSR over the prior five years.

  If these alignments appear weak, ISS will conduct further analysis to determine if there are mitigating factors.

- Board response to previous say-on-pay votes. ISS will make a case-by-case voting recommendation on compensation committee members and the management say-on-pay proposal if the company's previous say-on-pay resolution received less than 70% support. Companies that receive less than 50% support will be subjected to the highest level of scrutiny, but even companies with approval percentages between 50% and 70% will be subject to scrutiny. Companies that fall in this category may want to consider whether a company response to the vote would be a factor in future voting recommendations from the proxy advisory firms and then determine what response is appropriate. ISS will consider the following in making its voting recommendation:

  - The company's response, including compensation actions taken and disclosure of engagement with major investors. According to ISS, an appropriate response from a company that received a low approval percentage "must include disclosure of its outreach efforts to major institutional investors as well as concrete actions that it has taken or will take to address the compensation issue(s) that resulted in significant opposition;"

  - Whether the compensation issues that contributed to low levels of support are recurring or one-time events;

  - The company's ownership structure; and

  - Whether the say-on-pay resolutions received less than 50% support.

- Board response to frequency of say-on-pay advisory vote. ISS will recommend voting against all incumbent director nominees if a board implements a say-on-pay vote on a less frequent basis than the frequency that received a majority of votes cast at the preceding annual shareholder meeting.

- Proxy access. ISS will continue to recommend voting on a case-by-case basis on proxy access shareholder proposals, but revised its policy to expand the factors that will be considered in its evaluation of proxy access proposals, including:

  - The proposed percentage and duration of ownership thresholds;

  - The maximum proportion of directors that shareholders may nominate each year; and

  - The method of determining which nominations should appear on the ballot if multiple shareholder groups submit nominations.

  ISS will not consider the proponent's rationale or whether the proposal is binding or advisory as core factors, although either may be considered as one of a number of other factors.

- Political spending proposals. ISS changed its policy on reviewing shareholder proposals to limit or disclose political spending to generally vote in favor of such proposals, instead of on a case-by-case review basis. However, ISS will consider additional facts and circumstances in its evaluation, including current company disclosure of existing policies and oversight mechanisms for political contributions.

- Director elections and risk. ISS has expanded the factors it will consider in recommending "no" or "withhold" votes in uncontested director elections, now specifically adding material failures of risk oversight to the list. Other principal factors to be considered include material failures of governance, stewardship, or fiduciary responsibilities at the company.

Shareholder Proposals

Popular shareholder proposals in 2011 included:

- Proposals for board declassification (receiving average support of 73.5% of votes cast);
- Majority voting in director elections (receiving average support of 59.2% of votes cast); and
- Separation of the chair/CEO positions (receiving average support of 32.8% of votes cast).

Other shareholder proposals included proposals to repeal supermajority voting requirements in charter/bylaws, shareholder rights to call special meetings, and shareholder rights to act by written consent.

NYSE Further Limits Broker Voting on Corporate Governance Proposals

On January 25, 2012, the NYSE announced a change in the application of NYSE Rule 452 that will further restrict the ability of brokers to vote their customers' shares without specific client instructions. Rule 452 allows NYSE member organizations to vote uninstructed customer shares on certain uncontested "routine" matters. Broker voting of uninstructed shares has fallen into increasing disfavor in recent years, however, and the matters on which brokers may vote uninstructed shares has narrowed considerably. In 2010, Rule 452 was amended to prohibit broker voting of uninstructed shares in the election of directors, and the NYSE also prohibited broker voting of uninstructed shares on executive compensation matters as a result of Dodd-Frank.

In the past, the Exchange has ruled certain corporate governance proposals as "broker may vote" matters for uninstructed customer shares when the proposal in question is supported by company management. In keeping with recent trends that disfavor broker voting of uninstructed shares, the new NYSE guidance, effective immediately, designates the following additional corporate governance matters as "broker may not vote" matters even if supported by the company:

- Declassifying a company's board of directors;
- Majority voting on the election of directors;
- Eliminating supermajority voting provisions in a company's governing documents;
- Providing for the use of written consent;
- Providing the right to call a special meeting; and
- Certain types of anti-takeover provision overrides.

As a result of the NYSE's new position, it may be significantly more difficult for companies to obtain approval of these types of proposals, particularly with respect to companies seeking support for proposals requiring approval of a majority of the shares outstanding or companies subject to a default majority voting standard. The ratification of auditors continues to be a "broker may vote" matter, however, so companies will still be able to use the broker vote to help them establish a quorum for shareholder meeting purposes.

SEC Staff Disclosure Initiatives Potentially Applicable to Form 10-K

European Sovereign Debt Exposure. On January 6, 2012, the SEC's Division of Corporation Finance issued disclosure guidance relating to registrants' exposure to European sovereign debt holdings. Although the guidance is primarily applicable to financial institutions, it is also valuable guidance for other registrants with significant exposure to European sovereign debt. The guidance identifies existing disclosure requirements where a discussion of European sovereign debt exposure may be warranted, including: (i) MD&A disclosure of certain known trends and uncertainties; (ii) risk factor disclosure; and (iii) market risk disclosure. The guidance recommends that registrants:

- In addition to providing gross funded exposure, provide disclosure separately by European country, segregate disclosure between sovereign and non-sovereign exposure and segregate by financial statement category;
- Consider whether to include disclosure of gross unfunded commitments; and
- Provide disclosure about hedges.

The guidance also provides an extremely detailed outline for registrants to consider when determining what disclosure is relevant and appropriate based on the registrant's particular circumstances.

Cybersecurity Risks. On October 13, 2011, the SEC's Division of Corporation Finance issued disclosure guidance intended to assist companies in assessing what disclosure should be provided with respect to cybersecurity risks and cyber incidents. Existing disclosure requirements do not explicitly refer to cybersecurity risks, but the guidance notes that certain current disclosure requirements may impose such disclosure obligations, including:

- Risk Factors. Risk of cyber incidents should be discussed if such risk is among the significant risk factors that make an investment in the company speculative or risky. Factors for consideration include: (i) prior cyber incidents; (ii) the severity and frequency of such incidents; (iii) the probability and magnitude of such incidents (including potential costs and consequences resulting from misappropriation of assets or sensitive information, corruption of data or operational disruption) and (iv) the adequacy of preventive actions to reduce cybersecurity risks.
- MD&A. Cybersecurity risks and cyber incidents should be addressed in the MD&A if (i) costs or consequences associated with known incidents or risk of potential incidents present a material event, trend or uncertainty reasonably likely to have a material effect on the company's results of operations, liquidity or financial condition; or (ii) would cause reported financials not to be necessarily indicative of future operating results or financial condition.
- Other disclosures. Depending on the circumstances, disclosure could also be required in other Form 10-K sections, including the company's "description of

business," "legal proceedings" or financial statement footnotes.

Leap Year Reporting Schedule for Form 10-K

The date that Forms 10-K will be due for calendar-year companies in 2012 will be affected by an additional day in February: February 29, 2012. Large accelerated filers will be required to file by February 29, 2012; accelerated filers will be required to file by March 15, 2012; and other filers will be required to file by March 30, 2012.

Updated SEC Schedule for Adoption of Dodd-Frank Act Governance Requirements

To be adopted between January – June 2012

- Compensation Committees and Consultants
  - Exchange listing standards regarding compensation committee independence and factors affecting compensation adviser independence
  - Disclosure rules regarding compensation consultant conflicts
- Disclosure rules related to "conflict minerals"
- Disclosure by institutional investment managers of votes on executive compensation

To be proposed between January – June 2012 and adopted by December 2012

- Rules regarding disclosure of pay-for-performance, pay ratios and hedging by employees and directors
- Rules regarding recovery of executive compensation (clawbacks)

This client update is intended to provide general information to our clients and should not be construed as legal advice. If you have questions regarding this client update, please contact your principal contact at Tonkon Torp LLP, or Tom Palmer (503.802.2018; tom.palmer@tonkon.com) or Andrea Schmidt (503.802.5703; andrea.schmidt@tonkon.com) of our Corporate Finance Practice Group. Visit us at www.tonkon.com.