January 21, 2009

SECURITIES ALERT

PREPARING YOUR FORM 10-K AND PROXY STATEMENT: RECENT CHANGES AND CONSIDERATIONS

Companies preparing their annual reports and proxy statements should keep in mind some recent rule changes and other developments that may affect their disclosures in these documents. While there are only a few rule changes relating to the Form 10-K and the annual proxy statement, the SEC's Division of Corporation Finance has issued new Compliance and Disclosure Interpretations (C&DIs), and SEC staff have spoken on several recent occasions about disclosure matters related to these documents. Many companies will have already addressed certain of these items in their third-quarter Form 10-Q disclosures but should again review the guidance below and update and revise their disclosure as necessary for their upcoming filings.

ANNUAL REPORT ON FORM 10-K

Although there are no new Form 10-K requirements for 2009, companies need to carefully assess the adequacy of their disclosures in light of the financial crisis and the deepening recession. Some particular areas of focus include—

Management's Discussion and Analysis. SEC staff have emphasized that companies should take a fresh look at their MD&A disclosures in light of market conditions and the unprecedented events of the past year. SEC staff have also recommended that, in preparing their MD&A disclosures this year, companies should review the SEC's 2003 interpretive release on MD&A, which is still very relevant. The 2003 release is available here.

While the SEC will not be publishing any new formal guidance on what companies should be discussing in MD&A, several presentations by SEC staff members at the December 2008 AICPA National Conference on Current SEC and PCAOB Developments highlighted important items that companies should consider in the current environment. Not all of the SEC staff presentations at this conference have been posted on the SEC's Web site, but many of the major accounting firms have published detailed reports of the conference that are very helpful. Click on the accounting firm's name to view these reports:

- Deloitte
- Grant Thornton

- KPMG
- PriceWaterhouse

We discuss below some of the major disclosure items that the SEC staff addressed.

- **Liquidity and Capital Resources**. Michael Fay, Associate Chief Accountant of the Division of Corporation Finance, noted that Liquidity and Capital Resources will be an area of focus for the SEC in its review of 2009 reports, particularly given the importance of this section in light of current market conditions. He suggested that companies approach their drafting of this section by concentrating, through the eyes of management, on the purpose of this section in its simplest terms, namely, "what the company's bills are and how it will pay them." SEC staff also emphasized the importance of providing "robust" disclosure of known trends and uncertainties that will have or are reasonably likely to have a material impact on a company's liquidity, capital resources or results of operation. SEC staff outlined in detail a variety of topics for which companies often provide inadequate disclosure and offered suggestions for ways that companies could improve their disclosure. For example, Mr. Fay's presentation included 10 considerations for preparing the liquidity and capital resources portion of MD&A.[1]

- **Fair Value Measurements**. In March and September 2008, the SEC sent "Dear CFO" letters to approximately 30 financial institutions, suggesting ways that they could improve the transparency of their MD&A disclosures concerning fair value measurements under Statement of Financial Accounting Standards No. 157. The forms of these letters are available here and here. The SEC and the Financial Accounting Standards Board (FASB) issued additional guidance in the fall of 2008 regarding the determination of the fair value of securities. This guidance is available here and here.

  At the AICPA conference, several SEC staff members discussed the challenges surrounding fair value measurements in the context of the current market turmoil. In addition, Stephanie Hansaker, Associate Chief Accountant of the Division of Corporation Finance, presented a "Top Ten List of Best Practices for Fair Value MD&A Disclosures." Descriptions of these best practices can be found in the reports by the various accounting firms noted above.

- **Material Impairments**. Under applicable accounting rules, companies must test the book value of certain assets, including goodwill and other intangibles, for impairment against fair value. Recent declines in the market capitalizations of many companies may signal an impairment of goodwill carried on their balance sheets. At the AICPA conference, SEC staff addressed the circumstances that can trigger goodwill impairment and the level of disclosure that is required. SEC staff also suggested that companies provide early warning disclosure in their MD&A regarding certain events that may require an impairment charge in the future. Also, on January 12, 2009, FASB staff issued a new staff position that amends impairment guidance relating to securitized financial assets. The new guidance is available here.

[1] See slides 76-87 of the SEC staff's PowerPoint presentation, "Current Developments in the Division of Corporation Finance, National Conference on Current SEC & PCAOB Developments" (December 9, 2008), available at http://www.sec.gov/news/speech/2008/spch120908wc-slides.pdf. In addition, for very helpful summaries of the SEC staff's oral statements on this topic, see pages 20 and 21 of Grant Thornton's report on the conference (chart format) and pages 61-64 of KPMG's report.

Risk Factors. Companies are required to include in their Form 10-K, under the caption "Risk Factors," a discussion of the most significant factors that would make an investment in the company's securities speculative or risky. Companies will need to carefully review the adequacy of their risk factor disclosure in light of the financial meltdown and ensuing global economic crisis. In updating this disclosure, SEC staff have cautioned that companies should avoid boilerplate discussion of general economic conditions and "laundry lists" of risks that are not specifically tailored to the company's situation.

Many of the known trends and uncertainties that are discussed in MD&A will also be appropriate for discussion under "Risk Factors." In addition, companies should review the risk factor disclosures being made by their competitors, as well as by customers and suppliers. Based on a review of third quarter Form 10-Qs, likely additional risk factors include liquidity risks, decline in consumer spending, hedging risks and exposure to commodity price fluctuations, government regulation, macroeconomic factors and various counterparty risks involving customers, suppliers, lenders and other third parties with which a company deals.

In addition, in light of increasing pressure on public companies to provide more disclosure about climate change and greenhouse gas emissions, companies should carefully evaluate whether additional risk factor disclosure in this area is needed. Energy companies in particular should note that, in the fall of 2008, two major energy companies entered into settlements with the state of New York in which they agreed to provide additional disclosure in their Form 10-Ks.[2]

Safe Harbor for Forward-looking Statements. Companies may need to update the factors listed in their note on forward-looking statements to reflect changes made to their risk factor disclosures and to their other disclosures in their Form 10-Ks. To fall within the safe harbor for forward-looking statements, a company must disclose "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in their forward-looking statement."[3]

Smaller Companies. Effective February 4, 2008, the SEC adopted a new disclosure system for smaller reporting companies that phases out all of the Forms SB. The SEC also expanded the definition of "smaller reporting companies" to include not only companies that qualified as "small business issuers" under the old rules, but also most companies that qualify as "non-accelerated filers." A company now qualifies as a smaller reporting company if its public float was less than $75 million as of the end of its second fiscal quarter or if it had no calculable public float and had annual revenues of less than $50 million during its most recently completed fiscal year.[4]

Under the phase-in provisions, companies that formerly qualified as small business issuers had the option of filing their first annual report for a fiscal year ending after December 15, 2007, on either Form 10-KSB or on Form 10-K. However, all smaller reporting companies must file their annual reports for the just-completed fiscal year on Form 10-K.

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[2] For a more detailed discussion of this topic, see our client alert "Top 10 Topics for Directors in 2009" available here.

[3] Section 27 of Securities Act of 1933, as amended, and Section 21E of Securities Exchange Act of 1934, as amended.

[4] Once a company fails to qualify for smaller reporting company status, it will remain unqualified unless its public float was less than $50 million as of the last business day of its second fiscal quarter or, if that calculation results in zero because the issuer had no public equity outstanding or no market price for its equity existed, if the company had annual revenue of less than $40 million during its previous fiscal year.

Form 10-K now permits smaller reporting companies to comply with all of the disclosure requirements of Form 10-K or with certain reduced disclosure requirements. Due to declines in their market capitalizations, many companies may find that they are now eligible for the reduced reporting standards. In addition, in June 2008, the SEC granted non-accelerated filers a one-year extension of the requirement to file an auditor's attestation report on internal control over financial reporting. The report now must be filed with the Form 10-K for fiscal years ending on or after December 15, 2009. This change does not affect the requirement that management provide its assessment of internal control over financial reporting.

PROXY STATEMENT

As companies prepare their proxy statements for their 2009 annual shareholder meetings, they will need to address new rules, updated guidance and other considerations that will likely impact the proxy statement and related disclosures. These items are summarized below.

E-Proxy Now Mandatory for All Companies. As of January 1, 2009, all public companies must comply with the SEC's e-proxy rules. As a result, companies are required to post their proxy materials for their 2009 annual shareholder meeting on the Internet. In addition to posting proxy materials on the Internet, companies will need to determine which method of delivering their proxy materials will work best for their company. Under the e-proxy rules, companies can choose the (1) notice only option, (2) the full set delivery option or (3) a hybrid of these options.

There are several factors that companies should consider when choosing which delivery option to use. The notice only option will save the company money from postage and printing costs, but it will also accelerate the timing for completing and posting the proxy materials. The notice only option requires a company to send a Notice of Internet Availability of Proxy Materials to all shareholders and to post proxy materials on the Internet at least 40 calendar days in advance of the shareholder meeting date. Companies using the full set delivery option do not need to comply with this 40-day deadline. Other considerations relate to voting and quorum requirements, and whether the proposals to be voted on involve routine or non-routine matters. Based on results from companies using e-proxy in 2008, retail votes declined significantly for those companies using the notice only option. If the matters to be voted on at the annual meeting are routine, a decline in retail votes may not be an issue. However, if a company has non-routine matters on its meeting agenda and obtaining the requisite vote might be an issue, the company may want to consider using the full set delivery option or the hybrid option to increase the likelihood of getting the necessary vote.

Changes to Independent Director Tests. In light of recent changes by stock exchanges to their "bright-line" tests for determining director independence, companies should review their policies and procedures for evaluating director independence and should also update their director and officer questionnaires. The NYSE, Nasdaq and AMEX amended their bright-line tests relating to director compensation by increasing the amount of direct compensation that an independent director can receive from the company from $100,000 to $120,000. The revised test provides that a director will not be considered independent if such director (or an immediate family member of such director) has received more than $120,000 in direct compensation during any 12-month period within the last three years. These modifications are consistent with the dollar threshold for related person transactions under Item 404 of Regulation S-K.

In addition to the increased director compensation threshold, the NYSE also revised its director independence requirements relating to auditor affiliation. This amendment allows a director to have an immediate family member serving as an employee (but not a partner) of the company's auditor, provided the family member does not personally work on the company's audit. This amendment brings the NYSE's standard more in line with the standards required by Nasdaq and AMEX.

Change in Audit Committee Report. During 2008, the SEC amended Item 407 of Regulation S-K to reflect a new accounting rule that supersedes Independence Standards Board Standard No. 1.[5] As a result of this amendment, the language in audit committee reports must be revised to provide that "the audit committee has received the written disclosures and the letter from the independent accountant required by '*applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the audit committee concerning independence*' rather than the old reference of '*Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees), as adopted by the Public Company Accounting Oversight Board in Rule 3600T.*' In addition to modifying the audit committee report, companies should review their audit committee charters to determine whether any similar changes to the language are necessary.

Compensation Discussion and Analysis Disclosure Considerations. Companies should consider the following as they prepare their upcoming CD&A disclosure—

- **Changes to Executive Compensation Due to Market Conditions**. Companies need to carefully evaluate how the financial crisis and related events have affected their executive compensation programs. To the extent material, discussion and analysis will need to be included in the CD&A if the company took action—such as modifying or waiving performance targets, modifying awards or plans, implementing new plans or new awards or repricing or replacing existing options or other equity awards—due to a depressed stock price or the slowing economy.

- **Sensitive Pay Practices.** Boards should be mindful that actions and disclosures relating to executive compensation will face increasing scrutiny this year. Particular practices that can stir investor ire include excessive perquisites, excise tax gross-ups, absence of clawback policies after a restatement of financials, excessive golden parachutes, salary and bonus guarantees, single-trigger change in control provisions, and death benefits (golden coffin arrangements). Companies that use these compensation practices need to effectively communicate to investors why such practices are justified and necessary.

SEC Focus. After having two years to deal with new executive compensation disclosure rules, the SEC expects companies to step up this year with improved CD&A disclosure. In preparing CD&A, companies need to be particularly responsive to three aspects of the CD&A that the SEC is focused on: (1) analysis, (2) performance targets and (3) benchmarking.[6]

- **Analysis.** The SEC expects companies to provide more meaningful disclosure explaining the rationale for their executive compensation. To that end, companies should more clearly discuss (1) the material

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[5] SEC Release No. 33-8961 "Technical Amendment to Item 407 of Regulation S-K" (Sept. 26, 2008) at http://www.sec.gov/rules/final/2008/33-8961.pdf.

[6] John White, "Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009," Oct. 21, 2008, at http://www.sec.gov/news/speech/2008/spch102108jww.htm.

elements of compensation, (2) how they arrived at the varying levels of compensation and (3) why they believe their compensation practices and decisions fit within the company's overall objectives and philosophy. In doing so, companies should also attempt to eliminate boilerplate and unnecessary narrative disclosure. The SEC is encouraging companies to explain and place into context the specific factors considered when approving particular pieces of an executive's compensation package and to analyze the reasons why the company believes the amounts paid are appropriate. Companies should also include useful disclosure on whether they review each element of compensation individually or whether they engage in a collective evaluation of all components of executive pay when establishing the various forms and levels of compensation.

- **Performance targets.** The SEC continues to issue a significant number of comments relating to performance targets. If performance targets are material in connection with a company's executive compensation decisions, then the only basis for omission is a reasonable showing that disclosure would cause substantial competitive harm. Companies need to critically assess whether they have a sufficient legal basis for omitting performance targets. The SEC recognizes that several companies make a general conclusion at the time of filing and only do a thorough competitive harm analysis after receiving an SEC comment. But the SEC expects companies to do the analysis at the time of filing and to be able to substantiate a legitimate position rather than provide generalized arguments for determining that some form of harm might result from the disclosure. If a company concludes there is sufficient competitive harm for omission of the targets, then disclosure regarding the degree of difficulty in achieving or not achieving the performance target is required. Companies are also encouraged to review the SEC's updated C&DIs, which provide further guidance and information on determining whether a company may omit disclosure of performance target levels.[7]

- **Benchmarking.** Another important area of focus for the SEC is benchmarking, and how companies use this tool to make executive compensation decisions. With respect to the CD&A, the SEC has clarified that "benchmarking" entails using compensation data about other companies as a reference point to base, justify or provide a framework for a compensation decision but does not include a situation in which a company simply reviews a broad-based third-party survey to obtain a general understanding of current compensation practices.[8] If benchmarking is a material element of compensation, the SEC expects the company to identify those companies that comprise the peer group for benchmarking (even if this is a long list), as well as provide insight into the basis for selecting the peer group.[9] Companies should also disclose how they use the data collected from their analysis and how it relates to the actual compensation awarded to executives.[10]

TARP. Companies participating in the Troubled Assets Relief Program (TARP), will need to reflect in their CD&A the various executive compensation restrictions imposed on the company by the program, including[11]—

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[7] Regulation S-K Compliance and Disclosure Interpretations (updated as of July 3, 2008) Question 118.04, at http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm.
[8] *Id.* at Question 118.05.
[9] *Id.*
[10] *Id.*
[11] Companies that are seeking stockholder approval in the proxy statement for issuances of equity to the Treasury as part of the TARP Capital Repurchase Program should also consider the sample comments contained in "Staff Guidance for Financial

- stricter limits on deductibility of executive compensation under Section 162(m) of the Internal Revenue Code
- expansion of golden parachute penalties (20 percent excise tax and loss of corporate deductibility) under Section 280G of the Code
- prohibition on pay practices that encourage executive officers to take "unnecessary and excessive risks that could threaten the value of the financial institution"
- requirements that companies claw back bonuses and incentive pay of certain executive officers if the payment was based on materially inaccurate financial statements
- prohibition from making golden parachute payments to certain executive officers.

The Treasury has issued guidance relating to executive compensation provisions affecting companies participating in certain TARP programs.[12] In particular, compensation committees of financial institutions participating in certain TARP programs are required to meet with senior risk officers at least on an annual basis to ensure that the company's compensation arrangements do not include pay practices that encourage executives to take unnecessary and excessive risks. Compensation committees must verify that they have completed such reviews in the company's CD&A.[13]

In addition, SEC staff has suggested that it would be prudent for all compensation committees, when establishing targets and creating incentives, not only to discuss how hard or easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target.[14] Additional CD&A disclosure may be required if the compensation committee has evaluated pay practices to determine whether they encourage excessive risk-taking and has taken actions to curb those practices.

Compensation Consultants. In its updated C&DIs, the SEC has clarified where the discussion of compensation consultants should be located in the proxy statement. Regulation S-K Item 407(e) requires companies to describe the role of compensation consultants in determining or recommending the amount or form of executive and director compensation. Companies should include this information in their compensation committee disclosure. That said, if a compensation consultant plays a material role in the company's compensation-setting practices and decisions, this role should be discussed in the company's CD&A.[15]

Institutions Filing Proxy Statements in Connection with TARP Capital Repurchase Program" available at http://www.sec.gov/divisions/corpfin/cffilingguidance.htm.

[12] *See* Notice 2008-PSSFI, at http://www.treas.gov/initiatives/eesa/docs/Exec%20Comp%20PSSFI%20Notice.pdf. *See also,* Notice 2008-TAAP, at http://www.treas.gov/initiatives/eesa/docs/Exec%20Comp%20TAAP%20Notice.pdf and Department of the Treasury, TARP Capital Purchase Program Interim Final Rule, at http://www.treas.gov/initiatives/eesa/docs/Exec%20Comp%20CPP%20Interim%20Final%20Rule.pdf .

[13] Notice 2008-PSSFI, *supra* note 11 at Q-5. *See also*, Department of the Treasury, *supra* note 11.

[14] John White, *supra* note 6.

[15] Regulation S-K Compliance and Disclosure Interpretations, *supra* note 7 at Question 118.06 and 133.08.

Other C&DIs regarding Executive Compensation. In addition to the C&DIs discussed above, in July 2008 the SEC updated and added several other C&DIs, many of which relate to proxy statement and executive compensation disclosures.[16] Through C&DIs, the SEC addressed both substantive and technical issues by providing further guidance on, among other things, perquisites, disclosure of valuation assumptions relating to equity awards, cash compensation subject to forfeiture, tabular and narrative executive compensation disclosures, parent-subsidiary disclosures and disclosure of nonqualified deferred compensation.

[16] Regulation S-K Compliance and Disclosure Interpretations, *supra* note 7.

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