Securities Alert

Preparing Your 2013 Proxy Statement and Periodic Reports: A Checklist of Recent Changes and Considerations

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Companies preparing their 2013 proxy statements and other periodic reports should keep in mind some recent changes and other developments that may affect their disclosures in these documents. For 2013, there are only three new disclosure requirements with which companies *must* comply:

- All companies must disclose in their proxy statements any compensation consultant conflicts of interest.
- Smaller reporting companies must include in their proxy statements a say-on-pay vote and a say-on-frequency vote and report on Form 8-K how frequently the company will have a say-on-pay vote in light of the results of the say-on-frequency vote.
- All companies required to file annual or quarterly reports with the Securities and Exchange Commission (SEC) pursuant to Section 13(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), must report certain Iran-related activities undertaken by them or any of their affiliates during the period covered by the report.

While there are only a few new mandatory disclosure requirements, there are several other developments that companies should consider when crafting their disclosures for 2013. With respect to the proxy statement, these include:

- changes in the voting recommendation policies of the major proxy advisory firms
- recent SEC guidance on shareholder proposals
- a new trend in lawsuits challenging proxy statement disclosures
- a recent Delaware case challenging equity awards made to directors.

We address each of these changes and considerations in greater detail below.

PROXY STATEMENT CHANGES AND CONSIDERATIONS

1. Disclosure of Compensation Consultant Conflicts of Interest

Companies must determine whether any compensation consultant used in determining or recommending the amount or form of executive and director compensation during the company's last completed fiscal year involved any conflict of interest. If so, the company must disclose in its proxy statement the nature of the conflict and how the conflict is being addressed.[1] While the SEC did not define "conflict of interest," companies are required to consider the following factors in determining whether a conflict of interest exists:

- whether the person who employs the compensation advisor is providing any other services to the issuer
- how much the person who employs the compensation advisor has received in fees from the issuer as a percentage of that person's total revenue
- which policies and procedures that are designed to prevent conflicts of interest have been adopted by the person employing the compensation advisor
- whether the compensation advisor has any business or personal relationship with a member of the compensation committee
- whether the compensation advisor owns any stock of the issuer
- whether the compensation advisor or the person employing the advisor has any business or personal relationship with an executive officer of the issuer.

If the company determines that a conflict of interest exists, the company will need to include a concise and clear description of both the conflict and the manner in which it was addressed, not merely a description of the company's general policies and procedures on resolving conflicts. The disclosure requirement applies to any compensation consultant, whether retained by management, the compensation committee or any other board committee. However, the current exception under Regulation S-K Item 407 for compensation consultants who only consult with the compensation committee on broad-based plans or provide noncustomized benchmark data also applies to the new conflicts-of-interest disclosure.

To determine whether any conflicts of interest exist, the company will need to gather information from its compensation consultants, as well as from directors and executive officers. Accordingly, a questionnaire should be sent to any compensation consultants, and the company's D&O questionnaire should be updated to gather information on any personal or business relationships between an officer or director and any compensation consultant.

2. Say-on-Pay and Say-on-Frequency for Smaller Reporting Companies

When the SEC enacted the say-on-pay rules in 2011, it gave smaller reporting companies a two-year exemption from the rules. Starting with their first annual or other shareholder meeting at which directors will be elected occurring on or after January 21, 2013, smaller reporting companies must provide in their proxy statements for a shareholder advisory vote on the compensation of executive officers ("***say-on-pay***") and a shareholder advisory vote on the frequency of say-on-pay ("***say-on-frequency***").[2] Companies also must briefly explain in their proxy statements the general effect of such votes and whether they are nonbinding.[3] In addition, as discussed below, the company must disclose on Form 8-K the company's decision on how frequently it will have a say-on-pay vote in light of the results of the say-on-frequency vote.[4]

3. New SEC Guidance on Shareholder Proposals

The SEC staff recently issued a Staff Legal Bulletin[5] that provides guidance on several issues relating to shareholder proposals. Companies should carefully review the new guidance when determining whether to attempt to exclude shareholder proposals from their proxy statements. Among other things, the guidance addresses the following:

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- *Verification of a Shareholder's Beneficial Interest*. Affiliates of DTC participants, and not just DTC participants, can provide sufficient proof of ownership on behalf of proponents for shares held through DTC.

- *Deficiency Notice*. If a company attempts to exclude a shareholder proposal on the grounds that the proponent's proof-of-ownership letter does not cover the one-year period preceding and including the date the proposal is submitted, the company's deficiency notice must identify the specific date of submission and explain that the proponent must obtain a new proof-of-ownership letter verifying continuous ownership of the requisite amount of securities for the required period.

- *Website Address References*. The SEC provides guidance on a variety of issues relating to an issuer's ability to exclude a shareholder proposal due to inappropriate references to website addresses in the proposal or supporting statement.

4. ISS Policy Updates

ISS recently updated its proxy voting guidelines.[6] We summarize below some of the more significant changes for 2013:

- *Pay-for-Performance Evaluation*. ISS has made the following changes to its pay-for-performance evaluation:

  – *Peer Groups*. When evaluating pay-for-performance, ISS analyzes a company's pay practices and performance relative to the company's peer group. In the past, when choosing the peer group, ISS has focused on the company's industry group, size and market capitalization, which often led to a peer group significantly different from the company's self-selected benchmarking peer group. To address concerns about this disparity, ISS will now incorporate a company's self-selected benchmarking peer group into the peer group selection process.[7]

  – *Realizable Pay at Large-Cap Companies*. ISS has added realizable pay to the research report for large capitalization companies. A company's summary compensation table focuses on grant date pay, which shows the intent of a compensation committee's pay decisions on the grant date, but does not reflect how an executive's pay has been affected by performance and stock price fluctuations. Consequently, some companies have begun disclosing realizable pay in their proxy statements to better illustrate an executive officer's actual compensation. When undertaking its pay-for-performance analysis in 2013, ISS will consider both grant-date pay and realizable pay for large-cap companies. Realizable pay will consist of cash and equity-based grants and awards during a specified performance period, which will be measured based on equity award values for actual earned awards or target values for unearned awards, calculated using the stock price at the end of the performance period. Also, stock options or stock appreciation rights will be revalued with a Black-Scholes model using the remaining term and updated assumptions.

- *Hedging and Pledging*. ISS will consider hedging of company stock or significant pledging of company stock by executive officers and directors to be a risk oversight failure that can trigger a negative voting recommendation for some or all directors. ISS reasons that hedging transactions sever the alignment with shareholders' interests, and, therefore, any hedging will be considered a problematic practice warranting a negative vote recommendation. ISS also believes that pledging of company stock is not a responsible use of equity because of the detrimental impact it could have on shareholders if the director or officer is forced to sell. For those companies that have executive officers or directors who have pledged company stock, ISS will consider the following factors in determining its vote recommendations for the election of directors:

  – proxy statement disclosure of an antipledging policy that prohibits future pledging activities

  – the magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume

- proxy statement disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time
- proxy statement disclosure that shares subject to stock ownership and holding requirements do not include pledged company stock
- any other relevant factors.

In light of ISS's position on hedging and pledging, as well as a pending provision under the Dodd-Frank Wall Street Reform and Consumer Protection Act that calls for the SEC to adopt rules requiring companies to disclose in their proxy statements whether they allow employees and directors to hedge company shares, companies should carefully review and, if appropriate, revise their policies with respect to these matters. Companies may also want to disclose their hedging and pledging policies and any other relevant factors in their proxy statements to address shareholder and ISS concerns.

- *Overboarded Directors*. ISS recommends a vote against, or a withhold vote from, individual directors who (1) sit on more than six public company boards or (2) are CEOs of public companies and sit on the boards of more than three public companies. ISS will no longer count publicly traded subsidiaries that are owned 20 percent or more by the parent as one board with the parent company. Instead, each subsidiary with publicly traded stock will be counted as a separate board for this determination.

5. Glass Lewis Policy Updates

Key updates to Glass Lewis's proxy voting guidelines for 2013 include the following:

- *Pay-for-Performance and Peer Groups*. In July 2012, Glass Lewis revamped its pay-for-performance model. In analyzing pay-for-performance, Glass Lewis now compares a company to a single peer group using Equilar's Market Peers, rather than multiple peer groups developed internally by Glass Lewis. This results in greater emphasis on the company's self-selected peers and the peers disclosed by those peers. Glass Lewis also now uses a three-year weighted average of total compensation for the CEO and top five executives rather than one year. In addition, the performance metrics have been reduced from seven to five and grades are assigned on a relative basis, rather than on the basis of a forced curve.

- *Service by Executive Officers on Multiple Boards*. If an executive officer serves on more than two other public company boards, Glass Lewis will recommend a vote against the director at the other public companies, but not at the company where the director also serves as an executive officer.

- *Board Response to 25 Percent Vote Against Management.* Glass Lewis will carefully analyze the board's response in any situation where at least 25 percent of shareholders vote against management's recommendation on a proposal. Glass Lewis's analysis will include examination of publicly available disclosures of board actions in response to the shareholder concerns.

6. Other Considerations

Other considerations include the following:

- *Peer-Group Benchmarking*. In setting the pay of CEOs and other executive officers, boards of directors commonly use a company's peer group to benchmark how much executives at other companies are making and then, to be competitive with the peer group, target their compensation levels at the 50th, 75th or 90th percentile of the peer group. Although this methodology is commonly used, and believed necessary by many for executive retention, peer-group benchmarking has come under criticism. A recent study reveals some flaws in this methodology and shows that CEO skills are not readily transferable, CEO moves do not happen all that often and benchmarking executive pay at median or higher levels has contributed to the dramatic rise in executive compensation over the years.[8] In light of this study, some commentators have speculated that overreliance on peer-group benchmarking may be a new avenue of attack by the plaintiffs' bar. Peer-group benchmarking can give boards some helpful comparative information when the peer groups are honestly constructed, but benchmarking should just be one of many factors that the board considers when setting executive pay.

- *New Wave of Lawsuits Challenging Executive Compensation*. Following failed say-on-pay votes in 2011, shareholders at some companies filed suits claiming that directors had breached their fiduciary duties when making executive compensation decisions. For the most part, courts have dismissed these suits, holding that a failed shareholder say-on-pay vote does not rebut the business judgment rule presumption attached to a board's decision on executive compensation. Recently, the plaintiffs' bar has turned to a new tactic, filing class action lawsuits *before* shareholder meetings seeking to enjoin either a shareholder say-on-pay vote or a vote to amend an equity compensation plan on the grounds that the proxy disclosures are misleading and incomplete. In several instances, plaintiffs have successfully pressured companies to provide additional disclosure, obtained injunctions or obtained attorney's fees. Because this trend is likely to continue in 2013, companies should pay particular attention to the adequacy of their 2013 proxy disclosures.

- *Director Compensation*. Directors should also take extra care when determining their own compensation. The Delaware Chancery Court recently declined to dismiss a claim against a company's directors that they breached their fiduciary duties by awarding themselves equity grants that the plaintiffs claimed were excessive and amounted to corporate waste.[9] The defendants had argued that the awards, which consisted of time-vesting restricted stock units, were made under an equity plan that had been approved by stockholders and that the board's decision should be given the deference of the business judgment rule. The plan, however, gave the board broad discretion to determine the amounts and terms of the awards, subject to certain typical limits on the number of shares available under the plan and an annual cap on awards to individuals. The court ruled that there must be some *meaningful* limit imposed by the stockholders on the board of directors for the awards to be evaluated under the business judgment rule, and because there were no such limits, the board's decision was subject to review under the more exacting entire fairness standard, which requires the board to prove the fairness of the awards to the company.

  Companies planning to seek shareholder approval at their 2013 annual meetings of new equity compensation plans or amendments to existing plans may want to consider imposing additional limits on awards to directors. While the court did not specify the precise parameters of "meaningful" limits, the court noted that the plan in question imposed no limits on the total pay that could be awarded to directors, and, thus, the directors had "the theoretical ability to award themselves as much as tens of millions of dollars per year, with few limitations."[10] On the other hand, in an earlier Delaware case, the court ruled that directors were entitled to the protection of the business judgment rule when they awarded themselves stock options under a stockholder-approved director stock option plan that set specific ceilings on the awarding of options each year based on the type of service (such as service on a committee, position as a lead director or chairing the board).[11]

FORMS 10-K, 10-Q AND 8-K CHANGES

1. 10-K and 10-Q Disclosure of Iran-Related Activities

New Section 13(r) of the Exchange Act requires any company that is required to file annual or quarterly reports under Section 13(a) of the Exchange Act to report certain activities, primarily Iran-related, that the company or any of its affiliates knowingly engaged in during the period covered by the report. The new disclosure requirement applies to any annual or quarterly report required to be filed after February 6, 2013. The activities for which disclosure is required are generally illegal under U.S. law, and they include business activities relating to Iran's energy and financial sectors; dealings with the government of Iran; and dealings or transactions with terrorists, proliferators of weapons of mass destruction and their supporters.[12] In addition to a detailed description of each such activity, the company must disclose the gross revenues and net profits, if any, attributable to the activity and whether the company or affiliate intends to continue the activity. Concurrently with the annual or quarterly report, the company must file with the SEC a separate notice regarding the activity disclosed in the report.[13] The SEC must then deliver a report to the President, who is required to investigate and determine whether sanctions should be imposed.

The SEC staff recently issued some compliance and disclosure interpretations confirming, among other things, that:

- Section 13(r) applies to reports with a due date after February 6, 2013, and a company cannot avoid the required disclosures by filing early.
- Companies must disclose any targeted activities that occurred during the period covered by the report and not just those occurring after the statute's August 10, 2012, enactment date.
- There is no "negative" disclosure obligation to disclose that a company did not engage in any of the targeted activities.
- The definition of "affiliate" in Exchange Act Rule 12b-2 is to be used for purposes of Section 13(r). Rule 12b-2 defines an affiliate as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."

In view of the SEC's historical positions on affiliate status, issuers will need to update their disclosure controls and procedures to gather information not only from subsidiaries and other controlled entities, but also from joint ventures and other entities where control may be shared, as well as from any parent company and any sister companies with which the issuer may be under common control. In addition, directors, officers and major shareholders may be deemed to be affiliates. Consequently, companies should consider updating their D&O questionnaires in this regard as well.

2. Form 8-K Disclosure by Smaller Reporting Companies Regarding Frequency of Say-on-Pay Vote

As discussed above, smaller reporting companies must report on Form 8-K the company's decision, in light of the shareholder say-on-frequency vote, how frequently the company will include a shareholder say-on-pay in its proxy materials.[14] The disclosure can be included in the Form 8-K reporting the results of the meeting, or the disclosure can be included in an amendment to that Form 8-K so long as the amendment is filed within 150 days after the meeting, but in no event later than 60 days before the deadline for submission of shareholder proposals under Rule 14a-8 for the next annual meeting.[15]

Akin Gump Strauss Hauer & Feld LLP

CONTACT INFORMATION

If you have any questions concerning this alert, please contact—

Kerry E. Berchem
kberchem@akingump.com
212.872.1095
New York

Jeff Kochian
jkochian@akingump.com
212.872.8069
New York

Christine B. LaFollette
clafollette@akingump.com
713.220.5896
Houston

J. Kenneth Menges Jr.
kmenges@akingump.com
214.969.2783
Dallas

Seth Molay
smolay@akingump.com
214.969.4780
Dallas

Ackneil M. Muldrow III
tmuldrow@akingump.com
212.872.1064
New York

C. N. Franklin Reddick III
freddick@akingump.com
310.728.3204
Los Angeles

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[1] Regulation S-K Item 407(e)(3)(iv).

[2] SEC Rule 14a-21(a), (b).

[3] Schedule 14A, Item 24.

[4] Form 8-K, Item 5.07(d).

[5] Division of Corporation Finance, Staff Legal Bulletin No. 14G (CF), "Shareholder Proposals" (Oct. 16, 2012).

[6] ISS U.S. Corporate Governance Policy 2013 Updates (Nov. 16, 2012).

[7] On December 4, 2012, ISS published FAQs on its U.S. 2013 Peer Group Methodology.

[8] Charles M. Elson and Craig K. Ferrere, *Executive Superstars, Peer Groups and Over-Compensation – Cause, Effect and Solution*.

[9] *Seinfeld v. Slager, et. al.*, C.A. No. 6462-VCG (Del. Ch. June 29, 2012).

[10] *Id*. at 32.

[11] *In re 3Com Corp. Shareholders Litigation*, 1999 Del. Ch. LEXIS 215 (Oct. 25, 1999).

[12] Specifically, disclosure is required if the company or any affiliate:

(A) knowingly engaged in an activity described in section (a) or (b) of section 5 of the Iran Sanctions Act of 1996 (Public Law 104-172; 50 U.S.C. 1701 note)

(B) knowingly engaged in an activity described in subsection (c)(2) of section 104 of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (22 U.S.C. 8513) or a transaction described in subsection (d)(1) of that section

(C) knowingly engaged in an activity described in section 105A(b)(2) of that Act or

(D) knowingly conducted any transaction or dealing with:

(i) any person the property and interests in property of which are blocked pursuant to Executive Order No. 13224 (66 Fed. Reg. 49079, relating to blocking property and prohibiting transactions with persons who commit, threaten to commit or support terrorism)

(ii) any person the property and interests in property of which are blocked pursuant to Executive Order No. 13382 (70 Fed. Reg. 38567; relating to the blocking of property of weapons of mass destruction proliferators and their supporters) or

(iii) any person or entity identified under section 560.304 of title 31, Code of Federal Regulations (relating to the definition of the Government of Iran) without the specific authorization of a federal department or agency.

[13] Exchange Act § 13(r)(3).

[14] Form 8-K Item 5.07(d).

[15] *See* Form 8-K Item 5.07(d). The disclosure can also be included in another periodic report to the extent permitted by General Instruction B.3. *See* SEC Compliance and Disclosure Interpretation Question 121A.04.