

2013 PROXY SEASON UPDATE

13 Considerations for Public Companies

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#1: Dodd-Frank Rulemaking Developments Impacting Disclosure: Still to Come

- SEC still has work to do to complete its implementation of the public company related provisions of Dodd-Frank
- What's left:
 - Dodd-Frank Section 953(a)—Disclosure of relationship between executive compensation actually paid and the performance of the issuer
 - Dodd-Frank Section 953(b)(1)—Disclosure of (a) the median of the annual total compensation of all employees of the issuer, excluding the chief executive officer; (b) the annual total compensation of the chief executive officer; and (c) the ratio of (a) to (b)

Dodd-Frank Rulemaking Developments Impacting Disclosure

So what's left (*cont.*):

- Dodd-Frank Section 954—Directing each national securities exchange to require each listed company to implement a policy with respect to clawback from executive officers of incentive-based compensation in the event of an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement and to require disclosure of that policy
- Dodd-Frank Section 955—Disclosure re: whether employees and directors may purchase instruments that are designed to hedge or offset any decrease in the market value of the issuer's equity securities

#2: Dodd-Frank Rulemaking Developments Impacting Disclosure: Conflicts Minerals

- On August 22, 2012 SEC adopted Rule 13p-1 (effective November 12, 2012)
 - **Rule 13p-1. Requirement of report regarding disclosure of registrant's supply chain information regarding conflict minerals**

Every registrant that files reports with the Commission under Sections 13(a) of the Exchange Act, having conflict minerals that are necessary to the functionality or production of a product manufactured or contracted by that registrant to be manufactured, shall file a report on Form SD within the period specified in that Form disclosing the information required by the applicable items of Form SD as specified in that Form
 - Implemented Dodd-Frank Section 1502, which added Section 13(p) to '34 Act
- Humanitarian goal of stopping extremely violent conflict in the Democratic Republic of the Congo and surrounding countries (the "Covered Countries"), funded in part by the exploitation and trade of "**conflict minerals**"
 - Cassiterite and its derivative Tin
 - Columbite-Tantalite and its derivative Tantalum
 - Gold
 - Wolframite and its derivative Tungsten
 - Tin, Tantalum and Tungsten referred to as the 3Ts

Dodd-Frank Rulemaking Developments

Impacting Disclosure: Conflicts Minerals

- Disclosure is required by issuers that file reports under 13(a) or 15(d) of the Securities Exchange Act
 - Includes foreign private issuers, emerging growth companies (as defined under the JOBS Act) and smaller reporting companies
- **First Step:** Determine whether the rule applies
 - Issuers that Manufacture or Contract to Manufacture
 - Facts and circumstances analysis—degree of influence over manufactured products
 - Not deemed to have requisite influence if issuer:
 - Affixes its brand, marks, logo or label to a generic product manufactured by a third party
 - Specifies or negotiates contractual terms with a manufacturer that do not directly relate to the manufacturing of the product
 - Services, maintains or repairs a product manufactured by a third party

Dodd-Frank Rulemaking Developments

Impacting Disclosure: Conflicts Minerals

- Products that include Conflict Minerals
 - Necessary to the Functionality or Production of a Product
 - Contained in or intentionally added to product
 - Necessary to the product's expected function, use or purpose
 - Not primarily for ornamentation or decoration
 - Necessary to the Production
 - Does not include minerals used in production if not in final product (e.g., catalyst)
 - Does not include tooling
 - Does not include prototypes or demonstration devices

Dodd-Frank Rulemaking Developments

Impacting Disclosure: Conflicts Minerals

- If Rule applies to issuer, must file an annual Form SD (Specialized Disclosure)
 - Reporting is on a calendar year basis, regardless of the issuer's fiscal year end
 - Due by May 31 for the prior calendar year; first Form SD due May 31, 2014 for calendar year 2013
 - Filed (not furnished), signed by an "executive officer" but not subject to SOX CEO/CFO certifications
 - Posted on issuer's website for one year
 - Disclosure will always include Form SD; may or may not also include a Conflict Minerals Report as an exhibit and a related independent audit attestation

Dodd-Frank Rulemaking Developments

Impacting Disclosure: Conflicts Minerals

- **Second Step** (if Rule applies)—Reasonable country of origin inquiry (RCOI)
 - “Reasonable” inquiry depends on issuer’s particular facts and circumstances - size, products, relationships with suppliers, etc.
 - Must be a good faith inquiry
 - “Reasonably reliable representations” that minerals originated from a certified smelter or from scrap/recycled sources – SEC views as adequate, as long as issuer takes into account any “applicable warning signs or other circumstances” that indicate to the contrary
 - Outcome of RCOI? File **only** the Form SD if:
 - Conflict minerals definitively did not originate in a Covered Country or are from scrap/recycled sources
 - No reason to believe conflict minerals originated in a Covered Country or reasonably believe that conflict minerals came from scrap/recycled sources
 - If neither of the above, must conduct supply chain due diligence

Dodd-Frank Rulemaking Developments Impacting Disclosure: Conflicts Minerals

- **Third Step** (if necessary): Supply chain due diligence
 - Must follow a nationally or internationally recognized framework
 - Determine whether the conflict minerals came from a Covered Country or financed/benefitted armed groups in a Covered Country
 - If, through due diligence, issuer determines that conflict minerals did not originate in a Covered Country or were derived from scrap/recycled sources – note that in the specialized disclosure report on Form SD
 - Describe RCOI and due diligence process
 - Place description on website, and provide a link to website in Form SD
 - If not, must prepare and file conflict minerals report as exhibit to Form SD

Dodd-Frank Rulemaking Developments Impacting Disclosure

- Conflicts Mineral Report

- Description of due diligence measures and description of the products, the facilities used to process the necessary conflict minerals in those products, the country of origin of the conflict minerals in those products and efforts to locate the mine or location of origin with greatest specificity

either

- Representation that conflict minerals are “**DRC Conflict Free**” if issuer determines that conflict minerals in its products do not finance or benefit armed groups in the Covered Countries or are from scrap/recycled sources
 - Accompanied by an independent private sector audit

or

- Representation that conflict minerals are “**DRC Conflict Undeterminable**” – allowed in first two years (four years for smaller reporting company) only – no audit required but required to describe steps to mitigate the DRC conflict risk

#3: Dodd-Frank Rulemaking Developments Impacting Disclosure: Payments by Resource Extraction Issuers

- Also on August 22, 2012, the SEC issued disclosure requirements for “resource extraction issuers” making payments to governments
 - Implemented Dodd-Frank Section 1504
 - Issuer is subject to the requirements if it is a “resource extraction issuer”
 - Required to file with the SEC annual report on Form 10-K, Form 20-F or Form 40-F
 - Commercially develops oil, natural gas or minerals
 - Must disclose “payments” in excess of \$100,000 made either directly or through a subsidiary or controlled entity, to a foreign government, including subdivisions or the U.S. federal government
 - Covered payments include taxes (other than consumption), royalties, fees (license, rental, and entry), production entitlements, bonuses, dividends and infrastructure improvements

Dodd-Frank Rulemaking Developments Impacting Disclosure: Payments by Resource Extraction Issuers

- Must disclose payments on Form SD no later than 150 days after the end of the issuer's fiscal year
- Disclosure to be made in XBRL interactive data file as an exhibit to the Form
- Must comply with disclosure requirements for fiscal years ending after September 30, 2013
 - Issuers with fiscal years ending on December 31, 2013 will need to make a partial year report for payments between October 1, 2013 and December 31, 2013

Dodd-Frank Rulemaking Developments Impacting Disclosure: Legal Challenges

- U.S. Chamber of Commerce and industry groups have brought legal actions to block implementation of the SEC's conflict minerals and resource extraction payment rules
- Similar to successful challenge to SEC's proxy access rules
 - But there SEC rulemaking was permitted by statute
 - Here, the SEC rulemaking is mandated by statute
- SEC denied motion to stay effective date of resource extraction payment rules

#4: Compensation Committee and Adviser Independence - NYSE and NASDAQ Proposed Rules

- New Exchange Act Rule 10C-1 includes requirements that apply to Compensation Committees (CCs) and new disclosures related to CC advisers. (SEC Release No. 33-9330 (June 20, 2012))
 - Designed to implement Dodd-Frank Act Section 952
- Directs securities exchanges to establish listing standards requiring CC members to be independent board members and requiring CCs to have the sole discretion to retain compensation consultants and legal and other advisers
- Applies to any committee that oversees executive compensation, regardless of its formal title
- Most exchanges already have independence standards in place
- Rule 10C-1 does not define “independent” and instead directs exchanges and associations to develop independence standards considering both the directors source of compensation and their affiliation with the company or an affiliate

Compensation Committee and Adviser Independence - NYSE and NASDAQ Proposed Rules (cont'd)

- NYSE and NASDAQ filed proposed rules with the SEC on September 25, 2012
 - The SEC has not approved these rules but SEC approval is expected by January 13, 2013
- NYSE and NASDAQ proposed different independence standards
- Both the proposed NYSE and NASDAQ independence rules allow for a cure period in certain situations
- The proposed NASDAQ rules require that all NASDAQ listed companies have a CC (current NASDAQ rules do not require a separate CC)

Compensation Committee and Adviser Independence - NYSE and NASDAQ Proposed Rules (cont'd)

- Under the NYSE and NASDAQ proposed rules, CCs must have sole discretion to retain compensation consultants and legal and other advisers
 - CCs are required to be directly responsible for the appointment, compensation, and oversight of a compensation consultant or other adviser to the CC
 - Companies are required to provide funding for the advisers
 - The proposed NASDAQ rules require that the company adopt a written CC charter reflecting specified matters
 - Companies must certify that they have adopted a written charter and that the CC will review and reassess the charter on an annual basis
- Certain companies are exempt from these listing requirements (e.g. Limited Partnerships)

Compensation Committee and Adviser Independence - NYSE and NASDAQ Proposed Rules (cont'd)

- Companies must disclose conflicts with advisers in proxy statement for stockholder meetings where directors will be elected:
 - Revised Item 407 of Regulation S-K requires additional proxy disclosure addressing conflicts of interest of compensation advisers retained by management, the CC, or any other board committee
 - Use the six specified “Conflict Factors” in 10C-1(b)(4) when determining whether a conflict exists
- The NYSE and NASDAQ proposed rules require a CC to consider the above “Conflict Factors” and any other factors considered relevant by the Exchange before retaining such adviser
- Note that Rule 10C-1 does not require the compensation adviser to be independent - only that CC consider specified factors before selecting a compensation adviser

Compensation Committee and Adviser Independence - NYSE and NASDAQ Proposed Rules (cont'd)

- Proposed Timeline for New Rules:
 - NYSE Listed Companies
 - Would 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 would become effective on July 1, 2013
 - NASDAQ Listed Companies
 - Would be required to comply with the CC authorization and funding requirements immediately upon SEC adoption of the new rules
 - All other provisions of the new NASDAQ rules at the earlier of their second annual meeting held after adoption of final rules and December 31, 2014

Compensation Committee and Adviser Independence - NYSE and NASDAQ Proposed Rules (cont'd)

- CC Action Items:
 - Brief the CC (and perhaps the full board) on the proposed 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
 - 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 Proposed Rules (cont'd)

- Adviser Independence Action Items:
 - Assess whether the adviser is independent through the use of questionnaires, interviews or other methods
 - Determine whether conflict of interest disclosure will be required in the annual meeting proxy statement and whether disclosure controls are designed to identify these conflicts
 - If conflict exists, determine whether adviser will be changed
 - Revise D&O questionnaire to determine whether conflicts may exist between D&Os and advisers
 - Review CC Charter to determine if changes are needed to:
 - reflect independence considerations
 - provide authority to retain advisers and fund related expenses

#5: Say-on-Pay Developments

■ Coming off a 2012 season with:

- Average 91-92% support + 61 failed votes (*primarily P4P disconnects*)
- Continuing use of supplemental materials – *questionable impact*
- Generally compensation committee continued to be shielded from negative votes, with few institutional investor exceptions - *How long?*
- Increased and year-round shareholder and proxy advisory firm engagement, generating helpful ideas for:
 - *Changing problematic pay practices in off-season*
 - *Enhancing proxy disclosure and understanding*
- Almost 50% of companies that failed ISS's quantitative analytics still received FOR recommendations from ISS
 - *Showed how the “story” (especially over longer-term) counts in building general and qualitative analysis (to come)*

#5: Say-on-Pay Developments

■ New Developments for 2013 Proxy Season

- First time SOP votes for smallest companies – *consider getting a proxy solicitor as your “guide” for disclosure “story” + general inability to engage*
- More awareness of new SOP Litigation 2.0, trying to enjoin votes
- Less complacency about “red zone” votes or any one year’s vote
- More use of “realizable” pay as alternative to SCT pay for equity
- More directors participating in SOP-related engagement
- Refined SOP policies at proxy advisory firms (to come)
- Better proxy statement disclosure in CD&As (to come)

#6: SOP and the Impact on CD&A

- **Simply Complying with CD&A Rules is Not Enough!**
- **Analyze feedback from:**
 - Voting results – *estimated* + actual (N-PX filings)
 - Proxy advisory firms – *reports* + *engagement*
 - Your investors – *proxy* + *off-season engagement/feedback*
 - Your advisors – *proxy solicitor, lawyers, IR/PR/comp firms*
- **Use CD&A as “Sales Document” to Tell Your “Story”!**
 - Plain English, two columns and white space
 - Executive Summaries – REALLY = Key Reader “Checklist”
 - Charts, Graphs, Boxed Text, Color + “Visible” Sub-Headings
 - *Especially for “Pay-for-Performance” story*
 - *Love “Do’s/Don’ts” Charts/Checklists - also to explain “divergences”*

#7: Proxy Advisory Firm Updates: ISS

- **Peer Group Changes** – greater inclusion of company’s peers for “quantitative” Pay-for-Performance assessment for Say-on-Pay
 - *Opportunity to submit any company peer changes by December 21, 2012 on ISS web site at www.issgovernance.com/PeerFeedbackUS*
- **“Realizable Pay”** – to be incorporated into “qualitative” analysis for Say-on-Pay analysis of “large cap” companies
- **More “Stringent” Board Responsiveness Policy** – 1 year of majority of votes cast on shareholder proposals requires “board action”, or else ISS will recommend AGAINST/WITHHOLD for entire board (except new nominees)
- **No Hedging or Significant Pledging of Company Shares** – such instances will be considered risk oversight failures, likely triggering recommendations AGAINST/WITHHOLD for one or more directors

7: Proxy Advisory Firm Updates: Glass Lewis

- **New Equilar Alliance for Say-on-Pay Analysis** – basic methodology (of evaluating relative performance to relative pay) is the same, but will use Equilar’s market-based peers + company’s self-disclosed peers, with:
 - *“Grades” still based on Equilar’s peers*
 - *Greater emphasis on longer-term with more 3-year analysis*
- **More “Stringent” Board Responsiveness Policy** - Board should show some level of engagement + responsiveness if 25%+ vote AGAINST/WITHHOLD director nominee, AGAINST management proposal or FOR shareholder proposal
 - OR ELSE Glass Lewis may recommend AGAINST/WITHHOLD for one or more directors

#8: Shareholder Activism + “Hot” 2013 Shareholder Proposals: Year 2 of Proxy Access

- **Which Companies Will Be Targeted?** Generally expect same easy targets with long-standing governance concerns, which have not constructively engaged their shareholders.
 - *Of 24 tracked proposals this year, 13 went to a vote (including 7 binding ones, 4 from Norges with an average 34% vote), with ISS support for 6*
- **Which Parameters Will Be Most Successful?** Expect 14a-11 ones with 3 years/3% and 20-25% nominee limit, with less support for US Proxy Exchange’s 1%/100 holders if not excluded
- **Use of Rule 14a-8 SEC Exclusions?** Will companies begin to use conflicting management proposals as they have for special meeting proposal? At which levels?

#8: Shareholder Activism + “Hot” 2013 Shareholder Proposals: Majority Vote Standard for Director Elections

- Will remains important activist issue due to absence from Dodd-Frank, as activists target below S&P 500
- Still question of “teeth” – recent IRRC Institute study found only 5% failed elections led to director removals in past 3 years
- Active and mutually acceptable negotiations go on behind the scenes with proponents
 - RESPOND to calls + letters to avoid increasingly successful shareholder proposals (60.6% average vote in past proxy season, per Georgeson from S&P 1500) + publicity

#8: Shareholder Activism + “Hot” 2013 Shareholder Proposals: Reports/Policies on Political Contributions + Lobbying

- **2012 CPA-Zicklin Index of Corporate Political Accountability for top 200 companies in S&P 500** - showed that many companies changed their public disclosure and policies (and, in some cases, reduced activity), in response to shareholder proposals and Center for Political Accountability (CPA) activism, even in election year of surging spending
- **Expect continuing submission of shareholder proposals** – following recent mailing of letters from CPA and 13 investors to over 350 companies in S&P 500, urging enhanced political spending disclosure and accountability
- **Engage and use CPA as a resource**
(www.politicalaccountability.net)

#8: Shareholder Activism + “Hot” 2013

Shareholder Proposals: Independent Chairs

- **Increasingly Popular Proposal and Item for Investor Discussion** - averaged 35.9% in past proxy season (Source: Georgeson from S&P 1500)
- **Some Trend Toward Agreeing to do with Next CEO Change**
- **If Proposal is Received** - consider ISS criteria for “countervailing” lead director duties, in addition to certain positive governance/compensation practices
- **Norges has been Submitting “Binding” Proposals for 2013**
 - e.g., Cardinal Health, Harris Corporation and Clorox, but all excludable (per SEC) to date as “vague and indefinite”

#8: Shareholder Activism + “Hot” 2013

Shareholder Proposals: Miscellaneous Others

- **Board Declassification** - Harvard Law School's Shareholder Rights Project with 8 institutional investors, targeting 74 S&P 500 companies for 2013
 - *Follows 48 declassification commitments in 2012 +*
 - *Generally majority support for proposals (81% of votes cast for S&P 1500 recipients in first 6 months of 2012)*
- **Commitment to Board Diversity in Numbers + Policies**
 - 41 companies targeted with letters, proposals and engagement requests by 30% Coalition of, e.g., investors, industry leaders + national women's organizations
- **Shareholder Right to Act by Written Consent** -- still “hot” though average vote declining below majority of votes cast for S&P 1500 companies since re-appeared in 2010

#9-10: Financial Reporting & SEC Focus Areas

Key themes of following 10 topics—

- Discussion of significant estimates & judgments
- Enhanced quantitative disclosures
- Triangulation of financial disclosures & information from other sources

Financial Reporting & SEC Focus Areas (cont'd)

1. Revenue recognition

- Gross versus net
- Multiple element transactions
- Long-term contracts
- In top 3 restatement areas

2. Loss contingencies

- Disclosure of reasonably possible losses
- Consistency with other sources of information
- Removed from FASB agenda

Financial Reporting & SEC Focus Areas (cont'd)

3. Segment information

- Identification & aggregation
- Consistency with other sources of information

4. Management's discussion & analysis (MD&A)

- Critical accounting policies
- Results of operations
- Liquidity & capital resources

Financial Reporting & SEC Focus Areas (cont'd)

5. Non-GAAP financial measures

- Prominence relative to GAAP measures
- Explanation of why it is useful

6. Impairment of goodwill & intangibles

- Reporting units at risk
- Impairment testing policies
- Qualitative screening for testing

Financial Reporting & SEC Focus Areas (cont'd)

7. Income taxes

- Realization of deferred tax assets
- Key assumptions & estimates
- In top 3 restatement areas

8. Valuation of investment securities

- Distressed municipalities & countries
- Third party pricing services

Financial Reporting & SEC Focus Areas (cont'd)

9. Fair value disclosures

- Sensitivity analysis & quantitative disclosures
- Methods applied to significant populations

10. Guarantor financial information

- Qualification for modified reporting
- Presentation of consolidating information

#13 - Recent Form 10-K and Proxy Statement SEC Legal Comments

- Commercial Agreements
 - Specify terms, including contingent terms
 - Decision not to file agreements (contract on which the company's business is substantially dependent?)
 - Reasons for terminating agreement for new agreement; comparison of old and new agreements
- Data Security Risk Factor
 - Division of Corporation Finance initiative on cybersecurity disclosure; CF Disclosure Guidance: Topic No. 2 (October 2011)
 - Disclosure sections potentially implicated: risk factors, MD&A, business, legal proceedings, financial statements, disclosure controls and procedures
 - Severity and frequency of past security breaches of IT systems
- Executive Compensation
 - Performance goals
 - Factors behind Compensation Committee compensation determinations
- Legal Proceedings
 - Not just boilerplate
 - Conclusion as to likelihood of adverse outcome, loss contingency. Remote, material?
- Dealings with Certain Countries
 - Syria, Iran, Cuba
 - Time frame for satisfaction of existing commitments and withdrawal from country
 - Military uses?
 - Are customers institutions with divestment policies?

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