January 20, 2011

Considerations for 2010 Form 10-Ks and 2011 Proxy Statements

Although the past year has not seen a wholesale revision in the rules applicable to Form 10-Ks and proxy statements, there have been a handful of rule changes and the SEC staff has issued formal and informal guidance throughout the year on a variety of topics. This memorandum brings together the principal changes to keep in mind as we enter annual report and proxy season for calendar-year companies.

2010 Form 10-Ks

Liquidity Disclosure, Particularly Short-term Borrowing Practices. Liquidity and Capital Resources disclosure continues to be an area of staff focus. Earlier this year the staff issued immediately effective guidance on the disclosure of short-term borrowing practices, and proposed rules for specific disclosures. While it is unlikely that these proposed rules will be effective for 2010 Form 10-Ks, the staff is expecting enhanced disclosure in this area for affected companies. See the Davis Polk memorandum ***SEC Shines a Spotlight on Short-Term Borrowings: Issues Guidance and Proposes New Disclosure Requirements***.

Loss Contingency Disclosure. The FASB has deferred consideration of its **previously proposed amendments** to its loss contingency disclosure standards (known as ASC Section 450 (formerly FAS 5)) which means that they will not affect 2010 Form 10-Ks. The SEC staff has indicated, however, that it is taking a closer look at compliance with existing FASB standards for the disclosure of loss contingencies and pressing companies for additional and better disclosure under these standards. The staff issued a **"Dear CFO" letter** on disclosures related to foreclosures in October of last year in which it emphasized the need to disclose loss contingencies under existing standards as well as material trends and uncertainties. Staff members have also indicated that they are likely to question companies that announce a material litigation settlement without having previously disclosed the litigation.

Disclosure of Credit Ratings. Companies that reference credit ratings in their MD&A or other portions of their Form 10-K should remember that the Dodd-Frank Act repealed Securities Act Rule 436(g). As a result, except in certain circumstances, issuers must now obtain and file consents from rating agencies when credit ratings are included or incorporated by reference in registration statements or prospectuses. Disclosure of ratings in a filing with the Commission without the filing of a consent is still generally permitted in the context of a discussion of changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant, or the terms of agreements that refer to credit ratings. However, a plain description of credit ratings without accompanying liquidity discussion will require consent, which will likely not be forthcoming. See the Davis Polk memorandum ***Guidance on Use of Credit Ratings in Securities Offerings Following Dodd-Frank*** and the ***Securities Act Rules Compliance & Disclosure Interpretations 198.08 and 233.04 through 233.08***.

Mine Health and Safety. Section 1503 of the Dodd-Frank Act requires SEC registrants who operate coal or other mines to provide disclosure in their Form 10-K about their violations of health or safety standards. These Dodd-Frank requirements are already effective and should be included in this year's Form 10-K. The SEC has also issued pending **rule proposals** that would clarify the statutory requirements. See the Davis Polk memorandum ***SEC Proposes Rules to Implement Dodd-Frank Mine Safety Disclosure Requirements***.

2011 Proxy Statements

With proxy access stalled in litigation, the only new requirement for most companies in this year's proxy statement will be the inclusion of the shareholder advisory votes on say-on-pay and frequency required by Dodd-Frank. Companies should also be aware of informal guidance and comments from the staff this past year on the corporate governance disclosures that were new last year.

Shareholder Advisory Votes on Say-on-Pay and Frequency

The Dodd-Frank Act requires U.S. public companies to include two new non-binding advisory shareholder votes in their proxy statements for annual meetings held on or after January 21, 2011: a vote to approve executive compensation (the "**say-on-pay vote**") and a vote on the frequency with which the say-on-pay vote should be held (the "**frequency vote**").

The SEC has announced an open meeting on January 25th to finalize the rules. Pending that release, here are answers to some frequently asked questions about the new rules.

Say-on-Pay

- The scope of the vote is limited to executive compensation disclosure in the CD&A and executive compensation tables. It does not apply to director compensation disclosure or disclosure of compensation risk, other than risk related to executive compensation.
- We recommend that companies provide an executive summary in the CD&A describing their compensation practices, particularly as they relate to the company's performance and strategy, in order to make a concise case to shareholders in support of their executive compensation. This summary, again focusing on the relationship between the company's performance and compensation, should form the basis of the company's supporting statement for its say-on-pay proposal. Companies should view this supporting statement as an important element of their advocacy in support of their compensation practices.
- The SEC has proposed an amendment to Item 402(b) of Regulation S-K that would require companies to disclose in the CD&A whether, and to what extent, they considered previous say-on-pay votes in making executive compensation decisions. If this proposal is part of the final rules, then, for most companies, this requirement will not apply until the 2012 proxy season. The proposed rule is ambiguous as to whether companies that held say-on-pay votes in 2010, whether voluntarily or due to their participation in TARP, would be required to include this disclosure in their 2011 proxy statements. We believe that most companies will take the view that they should address the 2010 vote if there was one.

Frequency of Say-on-Pay

- Our review of proxy statements filed to date indicates that most companies, regardless of industry, are recommending a triennial frequency. It remains early in the season, however, and informal polls suggest that more later-filing companies may seek annual say-on-pay votes. We will start seeing the results of some of these votes at annual meetings next week, including whether companies recommending triennial votes are successful. Only a small number of companies have recommended biennial votes, and a few have chosen to make no recommendation at all.
- We advise that companies take the following considerations into account when recommending a particular frequency:
  - By now, most institutional shareholders have developed their view as to their preferred frequency, or are very close to doing so. Our anecdotal findings suggest that a number of prominent institutional investors will support a triennial frequency, which may be one

reason why there are so many early filers recommending this. Companies should consider polling their major shareholders prior to formulating a recommendation.

  - ISS, Glass Lewis and other shareholder advisory groups have, predictably, indicated that they favor annual votes. ISS has not yet developed any policy regarding companies that adopt a frequency different from that supported by the plurality of votes cast.
  - Companies also seeking shareholder approval of equity compensation plans may lean toward an annual vote so that they can demonstrate their receptivity to shareholder interests and focus their proxy solicitation efforts on their plans.
  - Companies with classified boards should note that a triennial frequency will cause the election of one class of directors to routinely coincide with the say-on-pay vote.
  - Most companies will be able to benefit from seeing how companies with upcoming meetings fare in making triennial recommendations. Several prominent companies with meetings early in 2011 have recommended triennial votes, including Monsanto (January 25), Johnson Controls (January 26), Costco (January 27), Air Products & Chemicals (January 27), Emerson Electric (February 1), Accenture (February 3) and Tyson Foods (February 4).

- Proxy cards must offer four options to shareholders: annual, biennial, triennial and abstention. As a transitional matter, if proxy service providers are unable to provide four voting options in the first year they may offer three options on the card and treat non-voted cards as abstentions. Companies should confirm the technical capabilities of their proxy service providers, which may change during the course of the season.
- TARP companies are required to hold say-on-pay votes on an annual basis and are therefore exempt from holding the frequency vote until they are no longer subject to the TARP requirement.
- As it is a general requirement, including say-on-pay and frequency votes in a proxy statement will not by itself trigger the requirement to file a preliminary proxy statement.

Corporate Governance Disclosures

The SEC staff has issued comments and informal guidance throughout the past year on the corporate governance disclosures that were new last year. This guidance should be helpful to companies as they prepare these disclosures for the current year.

Director Qualifications

Item 401(e) of Regulation S-K was amended last year to require companies to discuss, for each director or nominee, the specific experiences, qualifications, attributes or skills that led to the conclusion that the person should serve as a director, in light of a company's business and structure. The disclosure must cover more than five years if the information is material. Companies are expected to describe each of their directors on an individual basis, rather than grouping them by skill sets. Chairman Schapiro describes this disclosure as explaining "why a company's board members are the right people for their positions."

In last year's proxies, many companies addressed this requirement for the first time by adding a few sentences after each director's biography, pointing out particular aspects of the director's resume such as experience managing complex organizations or a background in the company's industry. In comment letters on this disclosure, the SEC staff often highlighted that the disclosure must address those specific qualifications or skills *that led to the conclusion* that a director should serve. In a **speech** last year, Chairman Schapiro also asked companies to be more illustrative in explaining why each particular director was chosen instead of just reciting additional biographical information or general characteristics, and gave the following example of good director qualifications disclosure:

> "Ms. Gray — of course, not her real name — says the filing — has spent her career in consumer businesses and brings key financial and operations experience to the Company….[she] possesses broad expertise in strategic planning, branding and marketing, business development, retail goods and sales and distribution on a global scale. Ms. Gray's positions as chief financial officer and her service on the audit committees of other companies…also impart significant expertise to the Board…Through her most recent experience…including with on-line selling, Ms. Gray provides the Company with valuable insight and guidance."

On the other hand, Chairman Schapiro expressed dissatisfaction with a proxy statement that presented biographical information for each candidate and then "merely add[ed] a sentence at the end of the section that essentially [said]: 'our directors each have integrity, sound business judgment and honesty, which are important characteristics of a good board member.'"

Board Leadership Structure

Item 407(h) of Regulation S-K, also new last year, calls for disclosure of board leadership structure, including whether and why the company has chosen to combine or to separate the principal executive officer and board chair positions, and why it believes that its leadership structure is the "most appropriate structure for it at the time of filing."

If the same person serves as the board chair and CEO, the company must make a statement as to whether or not it has a lead director, even if it does not have one. If a board has appointed such a director, then the company must also describe the director's specific role in the leadership of the board.

In addition, companies must discuss why they determined that their particular structure is appropriate given their specific characteristics and circumstances, in essence justifying their leadership structure in light of the demands of the organization. While there may be an implicit assumption that the SEC rules are directed more toward companies that combine the two positions, the staff will ask companies with separate chairmen to disclose why they have chosen to separate the positions.

Board Diversity

Item 407(c) of Regulation S-K requires companies to disclose whether, and if so, how, the nominating body (either a committee or the board) considers diversity in identifying nominees for director. If the nominating body has a "policy" with regard to the consideration of diversity in identifying director nominees, companies must describe how this policy is implemented, as well as how the nominating body assesses the effectiveness of its policy.

In comment letters, the SEC staff has indicated that it expects companies to provide a clear statement on whether or not boards consider diversity in identifying nominees. Some companies have attempted to finesse the issue by stating that diversity is a factor considered without stating whether they have a "policy." This approach may draw a comment asking how diversity affects the board's evaluation of candidates, as well as whether the company has adopted policies governing board diversity. The result tends to be a definitive statement that no formal policy exists. Disclosing the existence of a policy would entail describing how well it works.

Board Risk Oversight

Item 407(h) of Regulation S-K requires a discussion of the board's role in risk oversight and the effect of risk oversight on the board leadership structure. This may involve describing how the board's role in risk oversight has affected its leadership structure, such as whether having a combined CEO and chairman provides a certain unique perspective on risk oversight.

In a **speech** that touched on this topic last year, Chairman Schapiro praised a proxy statement that began with a thorough discussion of the risk-related responsibilities of the board and its various committees and then "add[ed] a detailed narrative that touches on the company's reporting to the Board and its committees about credit and liquidity risks, risk-focused auditing strategies, and the impact on risk of compensation policies." She indicated that she was not impressed by a risk oversight disclosure statement that read: "The board has risk oversight responsibility for Company X and administers this responsibility both directly and with assistance from its committees."

Compensation and Risk

Item 402(s) of Regulation S-K requires disclosure regarding the impact of a company's compensation policies and practices on its risk profile only to the extent that the risks are "reasonably likely to have a material adverse effect on the company." Many companies that were silent on the issue received an SEC comment asking them to advise the staff of the basis for their conclusion that disclosure is not necessary, and the process they undertook to reach that conclusion. As a result, companies may decide to include the disclosure in the first instance as the path of least resistance, including a brief summary of the basis for the conclusion and the process used.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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