

The Public Company Handbook:

A Corporate Governance and Disclosure
Guide for Directors and Executives

Fourth Edition

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RR DONNELLEY

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About this Handbook

Perkins Coie is pleased to share with you this *Fourth Edition of The Public Company Handbook: A Corporate Governance Guide for Directors and Executives*.

We have designed this practical and easy to digest guide for directors and executives of public companies. Directors and officers can face a bewildering task in understanding the myriad SEC, NYSE, Nasdaq and state law issues that apply to their organizations. The first step in fulfilling the duties of being a director or officer is getting a “lay of the land,” and that is what this slim volume seeks to provide. We’ve written this guide in a “plain English” style to discuss topics such as:

- The best “In the Board Room” corporate governance practices
- NYSE and Nasdaq requirements and guidelines
- Insider reporting obligations and trading restrictions for directors and officers
- Public disclosure obligations, including those under Regulations FD and G
- How to set up a Rule 10b5-1 Trading Plan
- How to establish an Annual Meeting/Proxy Calendar
- How to manage the Dodd-Frank Act rules and regulations

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Dedication

We dedicate this to our families. Margaret Breen, Hackett, Jamie and Owen Landefeld, Cori Gordon Moore, Toby and Margaret Moore, Susanne Wagner-Fischer, Maximilian and Sebastian Fischer, Jessica, Johanna and Rebecca Eiting, and Mark and Chris VanYe gave us patient support throughout the drafting and editing process.

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PLEASE READ THIS DISCLAIMER: This Handbook is intended to provide an informational overview to nonlawyers and is not intended to provide legal advice as to any particular situation. The laws and regulations applicable to public companies are complex and subject to frequent change. Experienced corporate and securities counsel should be consulted regarding the information covered in this Handbook. The views expressed in this Handbook are those of the authors only and do not necessarily reflect the views of Perkins Coie LLP.

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Chapter 1

You're a Public Company? What Does It Mean?

The Public Company Handbook is a practical guide for directors and executives of public companies.

A *public company* is a corporation, limited liability company or partnership subject to the regulations and disclosure requirements of the Securities Exchange Act of 1934 (1934 Act). Usually, this applies to entities that have completed an initial public offering (IPO) registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (1933 Act).

1934 Act Registration

The 1934 Act requires companies with a widely traded class of equity securities to register those securities with the SEC. 1934 Act registration is a one-time registration of an entire class of securities. By contrast, 1933 Act registration, an IPO for example, registers a certain number of securities for a particular public distribution. Two events trigger 1934 Act registration: listing on a national securities exchange or meeting certain size thresholds.

Listing on an Exchange

To list any securities for trading on a national securities exchange, a company must register the securities with the SEC under Section 12(b) of the 1934 Act. The company will also have to file a listing application and other materials with the exchange.

Meeting Size Thresholds

Alternatively, a company may trigger 1934 Act registration requirements simply by reaching a certain size. An issuer with a class of equity securities held of record by 500 or more persons and total assets in excess of \$10 million must register the securities under Section 12(g) of the 1934 Act. An issuer must register within 120 days after the last day of the fiscal year in which it meets both the shareholder and total asset size thresholds.



Trap for the Unwary: Stock Options Are a Class of Equity Securities

The 1934 Act defines *equity security* to include employee stock options. Does your company, before its IPO, have fewer than 500 shareholders but 500 or more option holders and more than \$10 million in assets? If so, the options, as a class of equity security, could trigger a requirement that your company register under Section 12(g) even though the common stock and the options themselves are not publicly traded. To avoid the burden of 1934 Act reporting, your company could rely on the exemption from registration under Section 12(g) found in Rule 12h-1 under the 1934 Act.

A non-reporting company may rely on the exemption from Section 12(g) registration of stock options if:

- The options are issued under a written compensatory stock option plan established by the company, its parents, or majority-owned subsidiaries of the company or its parents;
- The options are held only by employees, directors, officers, consultants and certain advisors of the company, its parents or majority-owned subsidiaries of the company or its parents.
- The options and, prior to exercise, the shares to be issued upon exercise of the options are not transferable other than to family members through gifts or domestic relations orders, an executor or guardian of the holder upon the death or disability of the

Trap for the Unwary: Stock Options Are a Class of Equity Securities (Cont'd)



holder and the company, or in connection with certain change-of-control or other acquisition transactions involving the company. The restriction on transfer applies until the company becomes a reporting company or is no longer relying on the exemption.

- The options and shares issuable upon exercise are restricted as to any pledge, hypothecation or other transfer by the holder prior to exercise of an option, except as noted in the prior bullet, until the company becomes a reporting company or is no longer relying on the exemption.
- The company has agreed in the written compensatory stock option plan, an individual written compensatory stock option agreement or another agreement enforceable against the company to provide certain risk and financial information required by Rule 701 under the 1933 Act. This information must be provided every six months and the financial statements must not be more than 180 days old.

The limitations on transferability set forth in the exemption must be included in the written compensatory stock option plans, individual written compensatory stock option agreements, another agreement enforceable against the company and the option holder or in the company's bylaws or certificate or articles of incorporation. Non-reporting companies that want to rely on the exemption from Section 12(g) should review their plans and agreements to determine if any revisions are necessary to comply with the requirements of the exemption.

The exemption will terminate if the non-reporting company no longer satisfies the conditions to the exemption. Likewise, the exemption will terminate once the company becomes a reporting company. A non-reporting company



Trap for the Unwary: Stock Options Are a Class of Equity Securities (Cont'd)

must file a registration statement to register the options under Section 12(g) within 120 calendar days after the exemption ceases to be available.

If a non-reporting company's plans or agreements comply with the exemption, it obviates the need to track the number of compensatory employee stock option holders for purposes of Section 12(g). However, the exemption does not apply to certain other classes of equity securities issued by a company. Accordingly, a company must continue to track the number of holders of other classes of equity securities, including those underlying the options, to avoid tripping the 1934 Act registration thresholds of Section 12(g) and becoming a public company.

The SEC Staff has confirmed that restricted stock units can be a separate class of equity security for purposes of the 500 holder Section 12(g) registration threshold. However, there are specific requirements that must be met to rely on an exemption for restricted stock units and companies must seek specific no-action relief from the SEC Staff.

There is also an exemption from Section 12(g) registration for compensatory stock options applicable to reporting companies that contains fewer limitations and conditions than the exemption for non-reporting companies.

Concurrent Registration Under the 1933 and 1934 Acts

Typically, a company will register its securities under the 1934 Act simultaneously with its IPO. This allows the company to list the securities offered in the IPO on a national securities exchange.

Form 8-A makes 1934 Act registration relatively simple for a company concurrently registering an IPO. Form 8-A is a shortened

registration statement that requires disclosure of general characteristics of the company's securities, including dividend rights, voting rights and any antitakeover provisions in the company's certificate or articles of incorporation and bylaws. This information is typically incorporated by reference from the company's IPO registration statement.

Practical Tip: The Inadvertent Public Company



Some companies become 1934 Act registrants simply because of a gradual broadening of the shareholder base as the company's shares are sold and resold in private transactions. Your company may trigger 1934 Act registration other than for the traditional reason of completing an IPO if, for example, it inadvertently crosses the size thresholds triggering 1934 Act registration. Without an IPO, your company would file a registration statement under the 1934 Act on Form 10. Form 10 requires financial statements and other more extensive disclosure than does Form 8-A.

1934 Act Periodic Reporting Requirements

A company with securities registered under Section 12(b) (exchange listing) or 12(g) (companies reaching a certain size) of the 1934 Act must file periodic reports with the SEC. As we describe in Chapter 2, a public company files annual, quarterly and current reports with the SEC.

Additional 1934 Act Regulation

In addition to periodic reporting, 1934 Act registrants and their directors, executive officers and significant shareholders are subject to the following requirements:

- The proxy rules;
- The tender offer rules;
- Section 16 reporting obligations and short-swing profit liability;

- Beneficial ownership reporting on Schedules 13D and 13G; and
- The listing standards of The Nasdaq Stock Market (Nasdaq), the New York Stock Exchange (NYSE) or other exchanges or listing services.



**Trap for the Unwary:
1933 Act Registration Alone Triggers 1934 Act
Periodic Reporting**

A company that has issued equity or debt securities to the public in an offering registered under the 1933 Act must file annual, quarterly and current reports with the SEC under Section 15(d) of the 1934 Act. This reporting requirement applies even though the company does not list the securities on a national securities exchange or market and the company has not crossed the size thresholds triggering 1934 Act registration. Companies subject to periodic reporting only by reason of Section 15(d) are free from a host of other 1934 Act requirements, including regulation of proxy solicitations and third-party tender offers, beneficial ownership reporting and short-swing profit liability.

In Chapter 13, we discuss the process by which a reporting company can cause its periodic reporting obligations to be suspended.

Chapter 2

The Basics: Public Company Periodic Reporting Obligations

A company subject to the 1934 Act files annual, quarterly and current reports with the SEC. These reports regularly update and supplement the information that the company has made available to the public in previous 1933 Act and 1934 Act filings. Companies file the reports within a specified number of days after the end of each reporting period or after certain material events.

**Practical Tip:
How to Keep Pace
With Periodic Reporting?
Maintain a Periodic Reporting Disclosure Checklist**



Corporate failures of the last decade have focused public attention on the integrity and quality of disclosures in companies' annual, quarterly and current reports. Congress mandated reforms to periodic reporting and corporate governance through the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and the SEC, the NYSE and Nasdaq have raced to keep pace. These initiatives have thrust the most basic of public company obligations – periodic reporting – into the forefront of directors' and officers' attention, and challenge even the most organized companies to keep track of what must be disclosed in reports filed with the SEC. In Appendix 1, we provide companies with a model Annual 1934 Act Reporting Calendar, which we discuss in greater detail in this and later chapters, and urge you to use it to create a comparable checklist for your company.

CEO and CFO Certifications and Disclosure Practices

Public company CEOs and CFOs must certify each annual report on Form 10-K and quarterly report on Form 10-Q. To ensure that a disclosure system is in place to backstop these certifications, each company must also maintain *disclosure controls and procedures* and *internal control over financial reporting*.

Certifications by CEO and CFO

A company's CEO and CFO are each required to provide two separate certifications in each Form 10-Q and 10-K, a "Section 302" and a "Section 906" certification. In a Section 302 certification, the CEO and CFO make statements in two areas:

1. *Accuracy of Report*. The officer has reviewed the report, and to the officer's knowledge:
 - The report does not contain any material misstatements or omissions; and
 - The financial statements, and other financial information included in the report, fairly present in all material respects the company's financial condition, results of operations and cash flows.

2. *Controls and Procedures*. The CEO or CFO is responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting, and has:
 - Designed the disclosure controls and procedures to ensure that all material information is made known to the CEO and CFO;
 - Designed the internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in conformity with generally accepted accounting principles (GAAP);
 - Evaluated the effectiveness of the disclosure controls and procedures as of the end of the period covered by the Form 10-Q or 10-K;

- Described in the Form 10-Q or 10-K the effectiveness of the disclosure controls and procedures based on the evaluation;
- Indicated in the Form 10-Q or 10-K whether there were any changes in the internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the internal control over financial reporting; and
- Disclosed to the company's auditors and Audit Committee any significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting or any fraud that involves employees who have a significant role in internal control over financial reporting.

In a Section 906 certification, the CEO and CFO make two basic statements that overlap with their Section 302 certification:

- The periodic report containing financial statements fully complies with the requirements of the 1934 Act; and
- Information contained in the report fairly presents, in all material respects, the company's financial condition and results of operations.

Unlike the Section 302 certification, the Section 906 certification may take the form of a single statement signed by both the CEO and CFO, and may be "furnished" rather than "filed" with the related report. (We discuss the difference between "furnishing" and "filing" later in this chapter.) Section 302 and Section 906 certifications are submitted as exhibits to Forms 10-K and 10-Q, and need not accompany reports on Form 8-K or 11-K.

Disclosure Controls and Procedures

To back up the certifications, companies maintain a system of disclosure controls and procedures designed to ensure that the company records, processes, summarizes and discloses on a timely basis information required to be disclosed in 1934 Act filings. Companies also need to evaluate on a quarterly basis the effectiveness of their disclosure controls and procedures. The phrase *disclosure controls and procedures* is broad in scope and extends beyond

financial matters to cover all controls and procedures relating to required disclosure, including interactive data. (We discuss interactive data filing, or XBRL, requirements later in this chapter.)

Internal Control Assessment

The most costly and controversial aspect of Sarbanes-Oxley is the internal control requirement of Section 404. Section 404 and related rules require each public company to include in its Form 10-K a management report on the effectiveness of the company's internal control over financial reporting. If the company is an accelerated or large accelerated filer (generally companies with market capitalizations of more than \$75 million), the company's independent auditor is required, in a separate audit-like analysis, to attest to, and report on, management's assessment.

Internal control over financial reporting includes policies and procedures that:

- *Track Transactions in Assets* – relate to the maintenance of records that in reasonable detail accurately and fairly reflect the acquisitions and dispositions of assets.
- *Control Receipts and Expenditures* – provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and directors.
- *Protect Assets* – provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements.

Management needs to base its internal control evaluation on some "recognized control framework" in order to have a widely accepted standard of comparison. The SEC identified the Treadway Commission's Committee of Sponsoring Organizations (COSO) report, "Internal Control – Integrated Framework," as the evaluation framework of choice. Although the SEC does not mandate any particular framework, U.S. companies quickly came to adopt COSO as the standard, indeed as the only realistic standard readily available for domestic issuers.

**Practical Tip:
COSO Provides Guidance
for Smaller Public Companies**



In the adopting rules under Section 404, the SEC and others expressed concern that existing internal control frameworks, including the COSO framework, are not appropriately tailored to a small business control environment and that, as a result, the costs and burdens of internal control assessments may fall disproportionately on smaller businesses. Due to these concerns, SEC Staff encouraged COSO to develop guidance on the use of its framework to address the needs of smaller businesses. In 2006, COSO released “Internal Control over Financial Reporting – Guidance for Smaller Public Companies,” which provides guidance on the use of its framework to address the needs of smaller businesses in fulfilling the requirements of Section 404. Specifically, COSO noted that smaller companies’ management tends to have a hands-on approach, wider spans of control and the ability to provide ongoing monitoring through direct relationships with key personnel, customers, vendors and capital providers that, along with in-depth knowledge of operations, processes, contractual commitments and business risks, can create opportunities for controls to be effective while being less formal. Daily interaction may be a practical tool for evaluating internal control over financial reporting because managers in smaller public companies are more directly involved with the company’s controls on a daily basis and fewer supervisory layers are present. COSO advises that efficiency can be achieved by focusing only on those reporting objectives directly applicable to the business, focusing on risk, right-sizing documentation (including determining when formal documentation is actually needed), viewing internal control components as an integrated process, and considering the totality of internal control components. Additionally, smaller public companies should consider utilizing software with built-in application controls to aid in internal control.

Methods of conducting evaluations of internal control will vary from issuer to issuer. Companies should review, among other

publications, COSO's "Guidance on Monitoring Internal Control Systems" released in 2009. This guidance expands on the guidance issued in prior COSO publications, including "Internal Control over Financial Reporting – Guidance for Smaller Public Companies." Although the SEC does not specify the methods or procedures to be used, it has made these observations that encourage documentation – one of the expensive side effects of internal control:

- *Develop – and Test – Procedures.* Management must base its assessment on procedures to evaluate the design of internal control over financial reporting. And management then should "actively" test its operating effectiveness, going beyond simple inquiry.
- *Results of Tests.* Management must base its assessment on evidence including documentation of the internal control design and on the process and results of testing.
- *Keep Records.* Companies should develop, and maintain in company records, documentation and other evidence that support management's assessment.
- *Outside Auditors Can Help Within Limits.* Management must be actively involved in the process and cannot delegate its responsibility to assess internal control to the auditor. But the SEC recognizes the need for coordination between management and auditors. For example, the auditors may provide advice and make recommendations for improvements to internal control, so long as management, and not the auditor, makes the accounting decisions. And someone other than the auditor (management or a third-party provider) needs to design the control procedures, because for an auditor to do so would place it in the position of auditing its own work and violate auditor independence rules.

If a company identifies a material weakness, it must disclose the existence of the material weakness in the Form 10-K, and management is not permitted to conclude that the company's internal control over financial reporting was effective for that period. The SEC defines material weakness to be a deficiency, or a combination of deficiencies, in internal control over financial reporting that creates a reasonable possibility that a material mis-

statement of a company's annual or interim financial statements will not be prevented or detected on a timely basis. The SEC encourages companies to provide additional disclosure to allow investors to assess the potential impact of the material weakness. Experience has shown that analysts and investors are, with sufficient information, able to quickly assess the impact, in many cases with no negative effect on stock price or company reputation. The SEC's suggested three topics are useful as a checklist for disclosure:

- The nature of the material weakness;
- Its impact on financial reporting and the control environment; and
- Management's plans, if any, or actions already undertaken, for remediating the weakness.

Practical Tip:
Form a Disclosure Practices Committee



Most widely traded public companies have followed an SEC recommendation to establish a non-Board "Disclosure Practices Committee." This Committee of officers and employees develops and oversees the procedures that support the CEO's and CFO's Sarbanes-Oxley certifications. The Committee's mandate is simple:

- Identify and analyze information for inclusion in 1934 Act reports;
- Develop, implement and evaluate disclosure controls and procedures and internal control over financial reporting (under the supervision of the CEO and CFO); and
- Review all SEC filings, press releases containing financial information or a discussion of material events, correspondence broadly disseminated to shareholders, presentations to analysts and the investment community, and disclosure policies for the company's corporate/investor relations website.



Practical Tip: Form a Disclosure Practices Committee (Cont'd)

Who serves on the Committee? Two to ten officers or employees from the key functional areas in your company best able to gather and analyze material financial and other information. The SEC suggests:

- Controller or principal accounting officer;
- General counsel or lawyer responsible for disclosure;
- Risk management officer;
- Investor relations officer;
- Human resource manager; and
- Internal audit manager.

Have your Disclosure Practices Committee meet at least three times during each quarter to fulfill its three categories of duties:

1. **Information Gathering.** Put into place and oversee the internal procedures for gathering information for possible disclosure in your company's 1934 Act reports. For example, interview personnel who have authority over significant business functions or subsidiaries.
2. **Review and Communication.** Analyze the materiality of information collected and communicate recommendations to management to allow timely decisions regarding required disclosures.
3. **Evaluation and Improvement.** Evaluate your company's disclosure controls and procedures and internal control over financial reporting. Identify weaknesses and recommend improvements.

The Committee or its chair will report its conclusions to the CEO, CFO and, possibly, the Audit Committee.

Forms 10-K and 10-Q Filing Deadlines

Forms 10-K and 10-Q filing deadlines depend on which of these categories of filers the company fits into:

- *Accelerated Filer.* Companies that:
 - Have a public equity float of at least \$75 million but less than \$700 million as of the last business day of the most recently completed second fiscal quarter;
 - Have been subject to the 1934 Act's reporting requirements for at least 12 calendar months;
 - Previously have filed at least one annual report on Form 10-K; and
 - Are not eligible to use the scaled disclosure requirements for smaller reporting companies for Forms 10-K and 10-Q.
- *Large Accelerated Filer.* Companies that have a minimum public equity float of \$700 million as of the last business day of the most recently completed second fiscal quarter and that otherwise meet the definition of accelerated filer.
- *Non-Accelerated Filer.* Companies that do not meet the definition of accelerated filer or large accelerated filer.
- *Smaller Reporting Company.* Companies that are not investment companies, asset-backed issuers or majority-owned subsidiaries of a larger reporting company parent and that:
 - Have a public equity float of less than \$75 million as of the last business day of the most recently completed second fiscal quarter; or
 - In the case of companies whose public float is zero (e.g., wholly owned subsidiaries and debt-only issuers), have less than \$50 million in annual revenues during the most recently completed fiscal year for which audited financial statements are available.

The table below summarizes the Forms 10-K and 10-Q filing deadlines for each category of filer:

Category of Filer	Form 10-K Deadline	Form 10-Q Deadline
Large Accelerated Filer (\$700+ MM)	60 days after year-end	40 days after quarter end
Accelerated Filer (between \$75 MM and \$700 MM)	75 days after year-end	40 days after quarter end
Non-Accelerated Filer and Smaller Reporting Company (less than \$75 MM)	90 days after year-end	45 days after quarter end



Practical Tip:
How to Prepare for Accelerated Filings?
Create a 1934 Act Reporting Calendar

Preparing your company's 1934 Act reports will require extensive input by your Disclosure Practices Committee and finance and legal departments, as well as review by external auditors and lawyers. Allow adequate time to complete each step of your disclosure controls and procedures and internal control over financial reporting, and for review by your CEO, CFO and your company's other officers and directors. To ensure that your working group remains on schedule, and to allow adequate review time, create a 1934 Act reporting calendar and circulate it to the members of the working group well in advance of each reporting cycle. Appendix 1 provides a sample Annual 1934 Act Reporting Calendar, including suggested Disclosure Practices Committee meeting dates.

Integrated Disclosure Under Regulations S-K and S-X

Regulation S-K, the SEC's disclosure guidance "cookbook," sets forth detailed disclosure requirements governing the content of 1934 Act periodic reports. Regulation S-K is a centralized source of disclosure requirements for periodic reports, proxy solicitations, registration statements and other filings pursuant to the 1933 and 1934 Acts.

Regulation S-X is the financial information counterpart to Regulation S-K. Regulation S-X provides the centralized source of requirements for the form and content of financial information required to be included in filings under the 1933 and 1934 Acts.

Scaled Disclosure for Smaller Reporting Companies

For some disclosure items, Regulations S-K and S-X provide *scaled* disclosure requirements for smaller reporting companies. For example, smaller reporting companies are only required to provide two years of audited income statements (instead of three years for larger companies) and are not required to include Compensation Discussion and Analysis (CD&A) disclosure (discussed in Chapter 5) in their Form 10-Ks or proxy statements. Smaller reporting companies may choose to comply with scaled or nonscaled financial and nonfinancial disclosure requirements on an item-by-item basis in any one filing. However, where the smaller reporting company requirement is more rigorous, the smaller reporting company must satisfy the more rigorous standard. For example, the related person transactions disclosure requirement (discussed in Chapter 5) is more stringent for smaller reporting companies, establishing a potentially lower dollar threshold and requiring a two-year look-back. Companies that meet the smaller reporting company standard should consult with counsel regarding these scaled disclosure requirements.

Interactive Data Exhibit Filings

In January 2009, the SEC issued final rules requiring companies to submit their financial statements, footnotes and schedules in an interactive data (ID) format, as exhibit 100 to their Form 10-Q or 10-K, as applicable, using eXtensible Business Reporting Language (XBRL). XBRL data-tagging is a format for enhancing financial

reporting data that can turn text-based information, such as filings available on EDGAR, into documents that can be more efficiently and effectively retrieved, searched and analyzed through automated means.

XBRL filing requirements have been phased in by the type and size of the reporting company and the level of legal tagging required. Beginning with the period ending on or after June 15, 2011, all reporting companies were required to include XBRL ID files with their periodic reports. ID files are excluded from corporate officer certification requirements and are generally subject to modified liability under federal securities laws; however, an ID file is part of the company's disclosure controls and procedures.

A company that maintains a corporate website must post on the website its financial statements as an ID file by the earlier of the end of the calendar day when the filing is made with the SEC or is required to be filed with the SEC. The ID file must be posted on the company's website for at least 12 months.

Annual Report on Form 10-K

A public company must file an annual report on Form 10-K following the end of each fiscal year. The first Form 10-K is due 90 days after the end of the first fiscal year in which the issuer becomes subject to the periodic reporting requirements of the 1934 Act. (We summarize the filing deadlines for subsequent years earlier in this chapter.)

Information Included in Form 10-K

Form 10-K is the most comprehensive periodic report filed with the SEC. It includes much of the same information that is required in a registration statement filed for an IPO under the 1933 Act. Required information includes:

- A description of the company's properties and business, including developments during the fiscal year;
- MD&A – management's discussion and analysis of financial condition and results of operations, including a table of the company's contractual obligations and a discussion of material off-balance sheet arrangements;

- Qualitative and quantitative disclosure about market risks (smaller reporting companies are not required to provide this disclosure);
- A description of material legal proceedings;
- “Selected” and full year-end audited financial information, including the independent auditor’s opinion, in compliance with Regulation S-X;
- Management’s conclusions regarding the effectiveness of the company’s disclosure controls and procedures as of the end of the fourth quarter; and
- Management’s report on internal control over financial reporting and (for accelerated and large accelerated filers) the related independent auditor’s attestation.

These items are also required, but companies that file a proxy statement within 120 days after the end of the fiscal year may meet these requirements by including these items in the proxy statement and incorporating them by reference into the Form 10-K:

- Information regarding directors, executive officers and more than 5% beneficial owners, including compensation, transactions with related parties and security ownership;
- Identification of the company’s Audit Committee financial expert or experts (if a company does not have at least one financial expert on its Audit Committee, the company must explain why);
- Identification of independent directors and committee members;
- Report of the Compensation Committee and any compensation committee interlocks (smaller reporting companies are not required to provide this disclosure);
- Whether or not (and if not, why not) the company has adopted a code of ethics for its principal executive officer, principal financial officer and principal accounting officer or controller;
- Textual and tabular information regarding equity compensation plans; and

- Disclosure of the fees billed by the company's independent public accounting firm for audit, audit-related, tax and other fees, and of the Audit Committee's preapproval policy for audit and nonaudit services.

Signatures

The company's principal executive officer, principal financial officer and principal accounting officer, and at least a majority of the members of the company's Board must sign the Form 10-K.

MD&A

The heart and soul of the Form 10-K is MD&A, management's discussion and analysis of the company's financial condition and results of operations. MD&A, governed by Item 303 of Regulation S-K, requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of the company's financial condition, changes in financial condition and results of operations.

In December 2003, the SEC issued detailed interpretive guidance regarding disclosure in MD&A, whose key concepts continue to be extremely helpful guideposts for the drafter of MD&A. The SEC developed its themes from recent experiences, including enforcement actions, its review of annual reports and a detailed review of the MD&A disclosure of Fortune 500 companies. The SEC emphasized these key concepts in its 2003 interpretive release.

Through Your Eyes: The Purpose of MD&A

- The purpose of MD&A is to enable readers "to see the company through the eyes of management" and to provide readers with the information they need to readily understand the company's financial condition and performance.

Overall Presentation

- Include an executive-level overview to provide a context for the presentation of MD&A.
- Encourage top-level participation in the drafting process.
- Give the greatest prominence to the most important information.

- Omit duplicative information, like information already included in financial statement footnotes.

Focus and Content

- What are the key performance metrics that management uses to run the business? Identify and discuss them.
- Focus on material information and eliminate the immaterial.
- Disclose known trends and uncertainties and their impact on the company's prospects. (This is *required* MD&A disclosure – not just a best practice – and a healthy MD&A will provide a thoughtful CEO's-eye view of trends.)
- Explain management's view of the significance of the information presented.

Substantive Guidance

- *Liquidity and Capital Resources.* Focus analysis on sources and uses of cash. In September 2010 guidance regarding MD&A liquidity disclosure, the SEC reminded companies to identify trends, demands, commitments and uncertainties relating to liquidity and capital resources, such as any trends or uncertainties relating to the company's ability to access the capital markets. In addition, the SEC advised companies to consider disclosure, where material, regarding intraperiod variations in liquidity and capital resources (for example, arising from the issuance of commercial paper), the company's cash and risk management policies and the nature and composition of the company's cash portfolio. Companies should also consider enhanced disclosure regarding debt instruments, guarantees and related covenants, such as leverage ratios.
- *Critical Accounting Estimates.* Consider enhanced discussion and analysis for accounting estimates and assumptions that are subjective and require judgments for highly uncertain matters. What are these estimates and assumptions and how are they susceptible to change, and how could a change have a material impact on financial condition or operating performance?



Breaking News: The SEC's Proposed Short-Term Borrowing Disclosure Rule

In September 2010, the SEC proposed a rule to further enhance liquidity and capital resources disclosure. The proposed rule would require quantitative and qualitative disclosure about short-term borrowings and applies to both annual and quarterly reports. The quantitative component would require tabular disclosure of a company's short-term borrowings, by category (such as commercial paper or bank credit facility) during a quarter, including:

- The amount and weighted average interest rate of each category as of quarter-end;
- The average amount of each category for the quarterly period and the weighted average interest rate of those borrowings; and
- The maximum month-end amount of each category for the quarterly period.

The qualitative component would require a narrative discussion of the company's short-term borrowing arrangements, including:

- A description of the arrangements in each category, including the business purpose of the arrangement;
- The importance of each arrangement to the company's liquidity, capital resources, market-risk support, credit-risk support and other benefits;
- The reasons for the maximum amount for the period; and
- The reasons for material differences between the average amounts for the period and the period-end amounts.

Check with your counsel regarding the status of this proposed rule, and consider whether voluntary compliance

Breaking News: The SEC's Proposed Short-Term Borrowing Disclosure Rule (Cont'd)



with some or all of these proposed disclosure requirements would enhance your liquidity and capital resources disclosure, even before a final rule is adopted.

Practical Tip: Pick Up the Pen! Ask Your CEO & CFO to Draft an MD&A Overview



Management should provide “early top-level involvement” in “identifying the key disclosure themes and items” to include in a company’s MD&A. These key themes should first appear in the “executive-level” overview. Although the content of an introduction or overview will depend on the circumstances of each particular company, the SEC suggests that a good overview will discuss:

- Economic or industrywide factors relevant to the company;
- How the company generates revenue, cash flow and net income;
- The company’s lines of business, locations of operations and principal products and services in a way that does not duplicate the Business section of the Form 10-K; and
- Material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company’s executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.

Ask your CEO or CFO to sketch out a one-page narrative or outline addressing these factors in his or her own words, or to discuss them with the principal MD&A drafter, to provide a “through the eyes of management” starting point for the MD&A overview.

In the SEC's recent focus on the quality of MD&A disclosure, it has re-emphasized the need to *identify* and *analyze* material trends, demands, commitments, events and uncertainties that could impact a company's liquidity, financial condition or operating results. This disclosure, the SEC believes, is critical to understanding a company's reported financial information and the extent to which reported information is indicative of future results or financial condition. SEC regulations require that MD&A focus on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or future financial condition. A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both:

- Presently known to management; and
- Reasonably likely to have a material effect on a company's liquidity, financial condition or results of operations.

The "reasonably likely" threshold is higher than "possible" but lower than "more likely than not." The SEC indicates that it expects disclosure of an identified trend, future event or uncertainty unless management concludes that either:

- It is not reasonably likely the trend, event or uncertainty will occur or come to fruition; or
- The trend or uncertainty is not reasonably likely to have a material effect on the company's liquidity, capital resources or results of operations.



Trap for the Unwary: Caterpillar's Samba With MD&A

The year 1989 was a profitable one for the Brazilian subsidiary of Caterpillar Inc. It accounted for 23% of the earnings of the Peoria, Illinois maker of heavy machinery engines. A number of nonoperating gains caused by hyperinflation and currency exchange rates contributed to the strong year.

Trap for the Unwary: Caterpillar's Samba With MD&A (Cont'd)



In its 1989 Form 10-K, as in years past, Caterpillar presented its financial results on a consolidated basis, melding the Brazilian subsidiary with the rest of the company. Its MD&A did not discuss the extent to which Caterpillar's 1989 earnings were derived from the subsidiary. Moreover, neither the Form 10-K nor Caterpillar's Form 10-Q for the first quarter of 1990 discussed what seemed to be known risks faced by the Brazilian subsidiary arising from possible economic reforms in Brazil that could have had a material adverse effect on the subsidiary's financial performance and the overall financial performance of Caterpillar.

When, in June 1990, Caterpillar announced that new economic policies in Brazil would hurt the company's overall earnings, its stock price plummeted by 16%.

The SEC charged Caterpillar with disclosure violations in a proceeding that centered on the MD&A section of the company's Form 10-K and first quarter Form 10-Q. In the SEC's release, which it still refers to today for MD&A guidance, the SEC described Caterpillar's MD&A disclosure as deficient in that:

- Caterpillar's Form 10-K should have discussed the impact of the Brazilian subsidiary on Caterpillar's overall results of operations; and
- Both the Form 10-K and the Form 10-Q should have discussed future uncertainties regarding the subsidiary's operations, the possible risk of Caterpillar's having materially lower earnings as a result of that risk and, if practicable, quantified the impact of the risk.

Caterpillar's experience reminds us that an MD&A that provides a view of the company "through the eyes of management" will:

- Transparently describe the contributions of subsidiaries, divisions or sectors;



**Trap for the Unwary:
Caterpillar's Samba With MD&A (Cont'd)**

- Disclose the risks, trends or uncertainties that may affect future financial performance, identifying them as they develop; and
- Quantify, where possible, the potential consequences of these risks.



**Trap for the Unwary:
Attention Kmart Investors:
SEC's MD&A Focus Continues**

In 2005, the SEC made the critical point that the text of a quarterly MD&A needs to accurately reflect management's views of the reasons behind balance sheet shifts. The SEC charged Kmart's former CEO and CFO for misleading investors about Kmart's financial condition in the months preceding a 2001 bankruptcy. According to the SEC's complaint, the former executives were responsible for materially false and misleading textual disclosure – not false financial data – in the MD&A section of a Kmart Form 10-Q.

The Form 10-Q disclosed a huge inventory build-up, but according to the SEC, failed to explain the “why” of the build-up and its impact on the company's liquidity. For example, while the SEC noted that a Kmart officer had made a reckless and unilateral purchase of \$850 million of excess inventory, the MD&A disclosure made the increase appear to be innocuous, as ordinary-course “seasonal inventory fluctuations and actions taken to improve our overall in-stock position.”

The lesson? Today, as it was in the Caterpillar case, “through the eyes of management” means the senior executives' view of the company needs to make the at times difficult translation to an accurate “word picture” in each quarter's MD&A.

Incorporation by Reference

Most companies' Form 10-Ks incorporate portions of the “glossy” annual report to shareholders and the proxy statement by reference,

without repeating the incorporated information. For example, companies generally incorporate by reference from the proxy statement all compensation information and related party transactions regarding directors and officers, known as Part III information. (We describe this information under “Annual Report on Form 10-K” above.) This is permitted even though the proxy statement is filed later than the Form 10-K. Incorporation by reference requires that:

- All the incorporated information be included in a definitive proxy statement that involves the election of directors;
- The company file its definitive proxy statement within 120 days after the end of the fiscal year covered by the Form 10-K; and
- The Form 10-K specifically identify the incorporated material by page, paragraph, caption or otherwise.

The Form 10-K may also incorporate by reference to the “glossy” annual report to shareholders. If so, the company must file the annual report with the SEC as an exhibit to the Form 10-K. (We discuss both the glossy annual report and the proxy statement in greater detail in Chapter 5.)

Risk Factors and the Safe Harbor

Most companies are required to include disclosure of risk factors in their Form 10-Ks. Risk factor disclosure involves a discussion of circumstances, trends or issues that may affect the company’s business, prospects, future operating results and financial condition. Although the SEC discourages companies from unnecessarily repeating the risk factors in their Form 10-Qs, companies filing Form 10-Qs will need to update their risk factors on a quarterly basis to reflect any material changes from the Form 10-K. This risk factor disclosure requirement does not extend to smaller reporting companies, although these companies will want to consider including this disclosure for the reasons discussed below.

Even if not mandated to include risk factors, many issuers include risk factors in 1934 Act reports in order to take advantage of the safe harbor provided by Section 21E of the 1934 Act. Sec-

tion 21E provides a public company with a safe harbor defense in securities litigation challenging a forward-looking statement made by the company. To fall within the safe harbor, the forward-looking statement must be identified as a forward-looking statement and be accompanied by meaningful cautionary language that, in the case of written statements, identifies important factors that could cause actual results to differ materially from those projected in the forward-looking statement. (We discuss and provide practical tips for using these safe harbors in Chapter 3.)

Periodic reports usually include forward-looking statements, particularly in the MD&A where the SEC encourages disclosure of forward-looking information. Risk factors accompanying these forward-looking statements will provide the meaningful cautionary language that identifies important factors that could cause actual results to differ from projected results. In addition, the company can protect oral forward-looking statements under the safe harbor provisions of Section 21E of the 1934 Act by referring to the most recent Forms 10-K and 10-Q risk factors.



Practical Tip:
Does Climate Change Affect Your Business?
Consider Disclosure

In February 2010, the SEC issued an interpretive release related to climate change disclosure for public companies, providing guidance to companies on how they should evaluate their existing disclosure requirements as they apply to climate change matters. The release focuses on disclosure obligations arising from changing regulatory, legislative and other business developments related to climate change, as well as physical changes such as weather and availability of resources, any of which could have a direct or indirect effect on a company's finances and operations. The interpretive release does not mandate specific disclosure, but rather directs companies to make their own materiality analysis. As you prepare disclosures in your Forms 10-K and 10-Q regarding your business, MD&A, legal proceedings and risk factors, consider the impact of climate change on your business and whether specific disclosure should be added.

Form 10-K Exhibits

Some of the most valuable sources of information about a public company are the exhibits to its Form 10-K. Item 601 of Regulation S-K identifies the documents to be filed as exhibits. (Companies generally incorporate by reference documents that they have previously filed as exhibits to other SEC filings.)

The most significant category of documents that must be filed as exhibits to Form 10-K is material contracts. All material contracts made outside the ordinary course of business must be filed as exhibits. If a contract was made in the ordinary course of business, it does not have to be filed unless it is material and falls within one of the following categories:

- A contract with a director, officer or shareholder named in the report;
- A contract on which the company is substantially dependent;
- Any contract involving the acquisition or sale of property, plant or equipment for consideration exceeding 15% of the company's fixed assets;
- Any material lease; or
- A management contract or compensatory plan for a director or executive officer that is not generally available to all employees.

All material contracts filed must include any and all exhibits and schedules attached to the contract unless confidential treatment is being requested for information in the exhibit or schedule. (We discuss confidential treatment later in this chapter.)

Quarterly Reports on Form 10-Q

Public companies file a quarterly report on Form 10-Q after the end of each of their first three fiscal quarters. (We summarize the filing deadlines earlier in this chapter.)

Information Included in Form 10-Q

Form 10-Q generally includes:

- Unaudited interim financial statements in compliance with Regulation S-X;
- MD&A;
- Qualitative and quantitative disclosure about market risks (smaller reporting companies are not required to provide this disclosure);
- Management’s conclusions regarding the effectiveness of the company’s disclosure controls and procedures as of the end of the quarter; and
- Any changes in the company’s internal control over financial reporting during the quarter that have materially affected, or are reasonably likely to materially affect, the company’s internal control over financial reporting.

MD&A in the Form 10-Q will include, among other disclosures, a textual update to the Form 10-K table of contractual obligations and a discussion of material off-balance sheet arrangements. In addition, a company will disclose specific events that occurred during the quarterly period, including:

- Material changes to the risk factors included in the Form 10-K; and
- Material legal proceedings and material developments during the quarter in previously reported legal proceedings.

Signatures and Certifications

A duly authorized officer signs a Form 10-Q on behalf of the company, as does either its principal financial or chief accounting officer. Unlike Form 10-K, Form 10-Q does not require CEO or Board signatures.

Although the CEO does not necessarily sign the Form 10-Q, the CEO and CFO each make the Section 302 certification and the Section 906 certification for each Form 10-Q.

Practical Tip:
Filing Your First Form 10-Q



Companies that go public during a quarter must file a Form 10-Q that covers the entire quarter in which the 1933 Act registration statement becomes effective. The first Form 10-Q after the company's IPO will include information regarding the status of the offering. Until all IPO proceeds have been applied, each post-IPO Form 10-Q must describe the use of the IPO proceeds.

Form 10-Q Exhibits

Item 601 of Regulation S-K identifies the documents that must be filed as exhibits to Form 10-Q. Companies may and generally do incorporate previously filed exhibits by reference.

Missed Form 8-K Filings

Form 10-Q must identify any information required to be disclosed in a Form 8-K during the quarter but not reported.

Current Reports on Form 8-K

Form 8-K is a current report filed between quarterly and annual reports to provide the public with information on recent material events. Form 8-K disclosure is mandatory if specified events occur. In addition, many companies make optional filings on Form 8-K to ensure maximum public disclosure of material developments. A duly authorized officer of the company signs the Form 8-K.

Mandatory Filing

Appendix 2 contains a complete list and description of the items a company is required to report on Form 8-K. These items include:

- Entry into or termination of, or material amendment to, material agreements;
- Significant acquisitions or dispositions;

- Specified financial information, including earnings releases, creation of direct financial obligations or off-balance sheet arrangements and events that accelerate or increase those obligations or arrangements, costs associated with exit and disposal activities and material impairments;
- Information regarding the company's securities and trading markets, including delisting notices or failure to satisfy listing standards, sales of unregistered securities and material modifications to rights of security holders;
- Matters relating to accountants and financial statements, including changes in the independent auditor and restatements of financial statements;
- Bankruptcy or receivership;
- Information regarding corporate governance and management, including changes in control of the company; departures or appointments of directors and executive officers; entry into, adoption of or material amendments or modifications to material compensation agreements; amendments to the company's charter documents, amendments or waivers to the company's code of ethics and suspension of trading under employee benefit plans; and
- The results of matters submitted to a vote of the company's shareholders.

**Trap for the Unwary:
Don't Forget to Disclose Decision
Regarding Say-on-Pay Vote!**



Companies are already required to disclose voting results pursuant to Item 5.07 of Form 8-K within four business days following a shareholders' meeting. This existing requirement will apply to the shareholder advisory vote on executive compensation, or Say-on-Pay vote, and on the frequency of the Say-on-Pay vote, or Say-on-Frequency vote. (We discuss the Say-on-Pay and Say-on-Frequency votes in detail in Chapter 5.) In addition, a company must disclose, in light of the Say-on-Frequency vote, its decision on how frequently the company will hold Say-on-Pay votes. This disclosure is provided by means of an amendment to the Form 8-K previously filed to disclose the voting results under Item 5.07 by no later than 150 calendar days after the date of the annual meeting, but in no event later than 60 calendar days prior to the deadline for the submission of a Rule 14a-8 shareholder proposal for the subsequent annual meeting. (We discuss Rule 14a-8 shareholder proposals in Chapter 5.) Your company should update your disclosure checklist to add the new Item 5.07 requirement to file an amended Form 8-K and should plan to schedule Board and/or committee meetings to consider the results of the Say-on-Frequency vote and reach a decision on your response in time to permit timely disclosure.

Optional Filing

A company may elect to voluntarily report other material events under Item 8.01 of Form 8-K.

Regulation FD Disclosure

Regulation FD requires that when a public company discloses material nonpublic information to certain shareholders and investment professionals, it must also simultaneously make general public disclosure of that information. Regulation FD public disclosure requirements may be met by reporting the information on Form 8-K under Item 8.01 or Item 7.01. (We discuss Regulation FD in detail in Chapter 3.)

Information provided on Form 8-K under Item 7.01 (and Item 2.02 – “Results of Operations and Financial Condition”) is considered “furnished” rather than “filed.” As a result, this information will not be subject to liability under Section 18 of the 1934 Act and will not be incorporated by reference into shelf registration statements filed under the 1933 Act.

Form 8-K Exhibits

Companies file exhibits with the Form 8-K report to the extent required by Form 8-K or Item 601 of Regulation S-K.



Trap for the Unwary: Best Practice May Be to File Material Agreement as Exhibit to Form 8-K When Practicable

The SEC encourages, but does not require, companies to file a copy of the reported material definitive agreement as an exhibit to the Form 8-K. Any agreement not filed as a Form 8-K exhibit will be filed as an exhibit to the company’s next periodic report or registration statement.

Because the Form 8-K disclosure must contain sufficient information not to be misleading, and must not contain any material misstatements or omissions, your company should take steps to ensure that all material information concerning an agreement is disclosed on Form 8-K. To ensure compliance with this requirement, many companies file agreements with Form 8-K, where practicable, to ensure that the disclosure is complete. However, if you are seeking confidential treatment of the agreement, you must submit your request for confidential treatment of sensitive information no later than the date that you file the Form 8-K which includes the agreement.

Timing

Mandatory Form 8-Ks generally must be filed within *four business days* of the reported event. An optional report made pursuant to Item 8.01 should be filed “promptly” after the triggering event. A

report made to satisfy Regulation FD requirements must be made within the timelines established by Regulation FD. (We discuss Regulation FD in detail in Chapter 3.)

Limited Safe Harbor From Rule 10b-5 Liability. Because several of the Form 8-K disclosure items require management to quickly assess the materiality of an event or to determine whether a disclosure obligation has been triggered, the SEC provides a limited safe harbor from claims under Rule 10b-5 under the 1934 Act for failure to timely file a Form 8-K. (We discuss Rule 10b-5 in Chapter 12.) The safe harbor applies only to these items of Form 8-K:

- Entry into, material amendment to or termination of a material definitive agreement;
- Creation of a direct financial obligation or an obligation under an off-balance sheet arrangement, and triggering events that accelerate or increase these obligations or arrangements;
- Costs associated with exit and disposal activities;
- Material impairments;
- The company's determination that a previously issued financial statement should no longer be relied on due to an error; and
- Entry into or adoption of, or material amendments or modifications to, material compensation arrangements, including material grants or awards made pursuant to the arrangements.

The safe harbor extends only until the due date of the next 1934 Act report for the period in which the Form 8-K was not timely filed. The safe harbor does not provide protection against, and the SEC may still bring, enforcement actions against the company under other 1934 Act rules for failure to timely file Form 8-Ks.

Failure to Timely File May Affect Form S-3 Eligibility. A company that fails to timely file a mandatory Form 8-K generally will lose its eligibility for a period of 12 months to use Form S-3, which is a streamlined registration statement form. (We discuss this registration statement in Chapter 11.) However, companies that fail to file timely reports on Form 8-K required solely by the Form 8-K

items for which the limited safe harbor described above applies will not lose their eligibility to use Form S-3. A company must be current in its Form 8-K reports, and have filed the disclosure required by any of these Form 8-K items, on or before the date on which it files a Form S-3.



Practical Tip:
**Integrate Form 8-K Filing Requirements
With Disclosure Control Mechanisms**

To meet the challenges of real-time reporting on Form 8-K, management should work with your company's Disclosure Practices Committee to monitor your company's disclosure controls and procedures and consider whether to design and implement new controls and procedures to ensure that someone at your company is identifying and evaluating information about events that may be reportable on Form 8-K – in a timely way for the deadlines.

Here are steps that may be useful in assessing and considering improvements to existing disclosure controls and procedures:

- Identify officers and others to whom the Board has delegated authority to execute material agreements or otherwise take actions that trigger Form 8-K disclosure obligations. Consider limiting the number of people who have authority to act on your company's behalf, and periodically remind this core group to be aware of when their actions can trigger a Form 8-K filing, and how the specific terms of an agreement can affect disclosure requirements.
- Evaluate current procedures for monitoring companywide contracting and compensation activities and events relating to existing contracts and compensatory arrangements. If current monitoring does not occur continuously or at least daily, consider implementing more frequent monitoring.
- Reconsider the size and composition of your company's current Disclosure Practices Committee.

**Practical Tip:
Integrate Form 8-K Filing
Requirements With Disclosure
Control Mechanisms (Cont'd)**



Consider forming a smaller “rapid response” sub-committee for Form 8-K disclosure to improve response time.

- Analyze current lines of communication from investor relations and each major function to and from the Disclosure Practices Committee (or your company’s general counsel or other appropriate person who staffs the Committee). Do the Investor Relations, Finance and other key groups understand these lines of communication? Have you built sufficient redundancy into the system to ensure that information flows to and from the Disclosure Practices Committee, even if one or more of the persons in the line of communication are unavailable?
- Evaluate existing procedures for identifying required disclosure for quarterly and annual reports. Consider whether additional procedures should be added to ensure that any missed Form 8-K disclosures are included in the Form 10-Q or 10-K.
- Review your company’s current material agreements that have been filed as exhibits to reports on Form 10-K, 10-Q or 8-K. Are these all still material?

Confidential Treatment

Sometimes the exhibit filing mandates of 1934 Act reports require disclosure of information that a company wants to keep confidential, such as pricing information in material contracts. The SEC allows a company to request confidential treatment of proprietary information if disclosure could harm the company’s competitive position and adversely affect its business and financial condition.

To make a confidential treatment request (CTR), the issuer submits a written application to the SEC, including a paper copy of the relevant exhibit that identifies its confidential portions, and simultaneously files a redacted version of the exhibit electronically with the 1934 Act report. The SEC will review and comment on the CTR application, sometimes requiring an amended application in response to its comments. Steps to a successful CTR process include:

- *File It on Time.* Any CTR must be made no later than the date the 1934 Act report is filed.
- *Find Your FOIA Exemption.* To receive confidential treatment, information must fall within one of nine exemptions articulated in the Freedom of Information Act. Most companies rely on the exemption that covers trade secrets and commercial or financial information.
- *Be Reasonable.* Generally redact only dollar amounts or formulas rather than entire sections of a contract. At times, when disclosure of the existence of the section would be commercially harmful, it is appropriate to redact the full section.
- *State Your Case.* Describe those aspects of the company's business or the specific contract that will allow the SEC to evaluate the sensitivity and importance of the information.
- *Be Aware of Off-Limits Information.* The SEC usually will not grant confidential treatment for information material to investors, nor will confidentiality be appropriate for disclosure required by Regulation S-K or any other applicable disclosure requirement.
- *Watch for Inadvertent Disclosure of Confidential Information.* Once the company has made information publicly available, even inadvertently, the company will not be able to receive confidential treatment for the disclosed information.
- *Specify Duration for Confidential Treatment.* Confidential treatment beyond the term of an agreement usually is inappropriate, although the company can file an additional CTR to extend the initial period.

SEC Review of 1934 Act Reports

The SEC is required under Sarbanes-Oxley to review a company's 1934 Act reports at least once every three years. The SEC may review a company's 1934 Act reports more frequently, however, often as part of an initiative to monitor specific companies. At other times, the SEC uses review to address specific issues (for example, disclosure of "critical accounting policies" and liquidity in MD&A or executive compensation disclosures). The SEC may also review 1934 Act reports in connection with its review of a company's 1933 Act registration statements.

Any SEC review may generate a comment letter to the company. The company will respond to the comments in a response letter to the SEC. Ultimately, the comment process could cause the company to amend the reviewed report.

Accelerated filers, large accelerated filers and well-known seasoned issuers must disclose, in their Form 10-Ks, written comments from the SEC in connection with a review of a 1934 Act report that:

- The company believes are material;
- Were issued more than 180 days before the end of the fiscal year covered by the Form 10-K; and
- Remain unresolved as of the date of the filing of the Form 10-K.

The disclosure must be sufficient to convey the substance of the comments. Companies may provide additional information, including their position regarding any unresolved comments.



**Practical Tip:
Look to SEC Comment Letters
for Disclosure Guidance. But Watch Out:
Your Response Letters Are Public Too!**

The SEC publicly releases SEC comment letters and company response letters on the SEC's website at <http://www.sec.gov/answers/edgarletters.htm>. Letters will be released by the SEC no earlier than 20 business days after the review of the disclosure filing is complete.

Although the SEC notes that comment letters reflect only the SEC Staff's position on a particular filing, do not apply to other filings and are not the official expressions of the SEC, the availability of comment and response letters can be a valuable resource to your company's disclosure team. Prior to making a filing, you will be able to review comments made to similar filings and potentially avoid issues encountered by other companies.

But remember, your response letters will be public too! Before submitting a response letter to the SEC, consider whether your letter includes confidential information that should be protected from public disclosure. If so, work with your counsel to develop an appropriate CTR for the portion of your response letter that contains confidential information.

Amending 1934 Act Reports

Amendments to Form 10-K, 10-Q and 8-K filings bear the letter "A" after the title of the form being amended (e.g., Form 10-Q/A). The amendment sets forth the complete text of the item that is being amended. For example, if Item 1 of Form 10-K (Business) is the only item that requires amendment, the filing need only include Item 1, but it must include the complete text of Item 1. Amendments are signed on behalf of the company by a duly authorized representative.

Applying Plain English Rules to 1934 Act Disclosure

Historically, the SEC's plain English rules applied only to prospectuses filed pursuant to the 1933 Act. However, the SEC encouraged plain English drafting in all SEC filings, and in recent years mandated it in 1934 Act risk factors and disclosures in 1934 Act reports regarding executive compensation, security ownership, related person transactions and corporate governance. As a result, many companies now use plain English throughout their 1934 Act documents. Companies should give strong consideration to converting their entire Form 10-K (and other periodic reports) to the plain English style.

Drafting in Plain English

Draft a plain English document in a clear, concise and understandable manner. Design the text to be visually inviting and easy to read. The SEC provides these guidelines:

- Present information clearly and concisely using short sentences and bullet lists whenever possible;
- Use descriptive headings and subheadings;
- Avoid frequent reliance on defined terms and glossaries;
- Avoid legal jargon, boilerplate language and highly technical business terminology;
- Use the active voice and definite, concrete and everyday language; and
- Use tabular presentations or bullet lists for complex material.

A highly accessible SEC guide to drafting plain English documents is *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*, available on the SEC's website at <http://www.sec.gov/news/extra/handbook.htm>. The Warren Buffett preface alone is a quick, amusing and useful read.

The EDGAR Filing System

Most documents filed with the SEC, including periodic reports on Forms 10-K, 10-Q and 8-K, must be filed electronically via the

SEC's Next-Generation EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system. Documents filed via EDGAR are available promptly on the SEC's website.

Companies can obtain the SEC's software package and make filings directly with the SEC or utilize an outside service provider, such as a financial printing company, to convert SEC filings to the EDGAR format and to file the documents on the EDGAR system. Prior to making filings on EDGAR, a company must obtain, via application to the SEC, a unique identification number, known as a CIK code, and a confidential password, to enable the company to log into, and be identified by, the EDGAR system.

Regulation S-T contains the rules and procedures for filing via EDGAR and supersedes many requirements in other SEC regulations and forms. For example, required signatures in an electronic submission must be in typed form rather than manual format. The company must obtain manually signed signature pages prior to each filing with the SEC and retain them for five years.

Liabilities Relating to Periodic Reporting

Public companies and their officers and directors face potential personal liability resulting from the failure to make required periodic reports or from making materially misleading statements in them. Companies and individuals can be subject to SEC enforcement actions or private civil actions, including class actions and derivative actions. (We discuss these liabilities in Chapter 12.)



Practical Tip: **Join a Board but Consider Your Timing**

Directors who join a Board shortly before the company files a 1934 Act report may be concerned about potential liability associated with the report, especially if they must sign a Form 10-K. Directors can take steps to minimize this liability and still meet their responsibilities:

- If you are comfortable that you can assimilate the company's business, schedule as many meetings with the company's management and independent

Practical Tip:
Join a Board but Consider Your Timing (Cont'd)



auditor as necessary. Sign the report only if you believe that you understand the company and the information in the report.

- If there is not enough time to conduct a sufficient review, wait to join the Board until after the company files the report.
- Join the Board but decline to sign the first Form 10-K report. (Directors are not required to sign a Form 10-Q, and only a majority of the members of the Board need sign the Form 10-K.)

Failing to comply with all securities laws requirements for periodic reporting may also cause an issuer to lose eligibility to use short-form 1933 Act registration statements. (We discuss these registration statements and their advantages in Chapter 11.)

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Chapter 3

Finding Your Voice: Public Disclosure Practices Under Regulations FD, G and M-A

Managing disclosures to shareholders and to the “street” – equity analysts, investment professionals and the financial press – presents CEOs, CFOs and investor relations officers (IROs) with the daily challenge of controlling the uncontrollable: human communication.

Mandatory and Voluntary Disclosures

Many of an issuer’s disclosures are *mandatory*. The 1933 Act, the 1934 Act, SEC rules, the NYSE and Nasdaq all require a variety of periodic reports and other filings. In addition, issuers make extensive *voluntary* disclosures – sharing news or facts with the market as part of a financial public relations strategy. The SEC recognized the realm of voluntary disclosures in issuing Regulation FD (short for *Fair Disclosure*), Regulation G (short for *GAAP* or generally accepted accounting principles), and Regulation M-A (short for *Mergers and Acquisitions*).

Public companies are not generally required to publicly disclose all material information at all times. But there are so many “triggers” of mandatory disclosure that it can seem like it! Mandatory disclosures must be made:

- In any 1933 Act registration statement, beginning with an IPO prospectus on Form S-1, and later in a Form S-3 or other forms;
- In every 1934 Act annual or quarterly report (Form 10-K or 10-Q);

- For every event for which Form 8-K (the 1934 Act “current” report) requires disclosure;
- Anytime a company is in the marketplace to buy or sell its stock (referred to as the “disclose or abstain” rule);
- When a company needs to confirm or correct a rumor that began with information leaked from the company, causing unusual trading activity likely to impact the marketplace;
- When required by exchange or Nasdaq requirements (Chapters 8 and 9 describe how the NYSE and Nasdaq call on companies to promptly release material information and to dispel unfounded rumors); and
- To update prior statements that the market considers current or “evergreen,” but which the passage of time has rendered inaccurate or incomplete.

In the 2000s, the SEC added three new categories:

- Regulation FD disclosure that precedes an intentional disclosure of material nonpublic information or that immediately follows an inadvertent disclosure of material information;
- Regulation G disclosure that accompanies an issuer’s voluntary release of pro forma or non-GAAP financial information; and
- Regulation M-A disclosure that requires targets and acquirers in mergers and acquisitions to file all their written communications on the date of first use.

Virtually all other communications by a public company, both formal and informal, are *voluntary*, including:

- Earnings calls in which the senior management team reports on earnings for the quarter or year, providing guidance regarding future financial results, and responds to analysts’ inquiries;
- Analyst conferences that investment banks organize to provide a forum for senior executives to discuss their company’s business, earnings and prospects with analysts and investors;
- Annual shareholders’ meetings;

- Website disclosures, including web logs, or blogs;
- One-on-one discussions with analysts or investors; and
- Press interviews.

Senior executives strive to maintain a dialogue with professional analysts, the financial press and major shareholders in order to help market professionals follow their company's stock and to provide shareholders with access to management. Reports that these equity analysts write and distribute to their customers in turn encourage investor interest and provide information. Yet, private discussions with analysts and major investors can create an imbalance of information, and prior to Regulation FD, institutional shareholders and professional analysts often had more information than other investors. The SEC issued Regulations FD and G to correct this imbalance.

In adopting Regulations FD and G, the SEC recognized the importance of issuers' voluntary, informal disclosures, which often inform investors more thoroughly and more promptly than mandatory 1934 Act reports.

How does Regulation FD seek, in the words of the SEC's adopting release, to put investors "on a level playing field with market insiders"? And how does GAAP-focused Regulation G provide a fairer picture of financial results? Regulation FD expands the quantity of information by requiring issuers to share with the public information that would otherwise be disclosed selectively. Regulation G requires more uniform quality of information by requiring reconciliation to GAAP of pro forma or non-GAAP financial information. Regulations FD and G together address the market's appetite for information by causing issuers to share high-quality information with the public, rather than with a mere handful of market professionals.

Regulation FD's Mandate: Share and Share Alike

Regulation FD requires a company to inform the public when the company, or a person acting on its behalf, voluntarily discloses material nonpublic information to securities market professionals or security holders, when it is reasonably foreseeable that the holders will trade on the basis of that information.

The timing of the company's public disclosure depends on whether the voluntary selective disclosure was intentional or unintentional.

- If *intentional*, the company must make public disclosure of material information *simultaneously* with any selective disclosure. In practice, companies disseminate material information to the public prior to disclosing the same information to a more limited audience.
- If *unintentional*, the company must make public disclosure *promptly* after the inadvertent disclosure of material information. *Promptly* means by the later of:
 - 24 hours after the inadvertent disclosure; or
 - The next opening of the NYSE.

(The SEC's 24-hour clock begins at the moment that a senior official of a company learns of the unintentional disclosure and recognizes the disclosed information to be both material and not publicly available.)

Trap for the Unwary:

IROs Can't "Go With the Flow" – SEC Penalizes Private Reaffirmation of Earnings Guidance



In a series of public statements from February to September 2002, Flowserve Corporation reduced its full-year earnings projections by more than 30%. The company then reaffirmed its September guidance in a press release issued on October 22, 2002.

During a private meeting almost a month later, on November 19, Flowserve's CEO responded to an analyst's question by again reaffirming the earnings projections last confirmed on October 22. The CEO's response was contrary to the company's disclosure policy:

Although business conditions are subject to change . . . the current earnings guidance was effective at the date given and is not being updated until the company publicly announces updated guidance.

Trap for the Unwary: IROs Can't "Go With the Flow" – SEC Penalizes Private Reaffirmation of Earnings Guidance (Cont'd)



Flowserve's director of investor relations, present at the meeting, remained silent. He neither paused the briefing to clarify the CEO's statement nor stopped to reiterate the company's policy and file a Form 8-K.

The next day, November 20, 2002, an analyst who had attended the private meeting issued a report highlighting the CEO's "no change" statement as news. Flowserve's stock rose approximately 6% on 75% greater volume, and the company filed a Form 8-K after the close of the markets on November 21 acknowledging that it had reaffirmed its earnings estimates earlier that week.

The SEC concluded that the CEO's reaffirmation was material information. It noted both that Flowserve had a trend of lowering its earnings guidance during the course of 2002 and that the markets reacted to the analyst's "no change" report. In a settlement agreement, Flowserve agreed to pay civil penalties of \$350,000 and its CEO paid \$50,000. Flowserve, its CEO and the director of investor relations all agreed to a cease-and-desist order.

Flowserve Lessons?

- As an IRO, speak up to protect your company! When you need to, interrupt your CEO and fellow officers to enforce your Regulation FD policy. Script discussions with professionals or shareholders, summarize your Regulation FD policy at the start of the meeting and set boundaries – including "off limit" topics such as earnings estimates older than a very few days unless you have issued an updating release.
- Jump in to a discussion and fix mistakes quickly. Have an understanding with your fellow spokes-



Trap for the Unwary: IROs Can't "Go With the Flow" – SEC Penalizes Private Reaffirmation of Earnings Guidance (Cont'd)

persons that when the inevitable mistake happens, and a "selective" disclosure occurs, you'll take a "time out." Pause and talk off-line with your IRO or general counsel. When you start again, reiterate your company's Regulation FD policy and correct the statement. Then disseminate the material non-public information in a press release, Form 8-K or both that day.

- Flowserve shows that to confirm guidance in private before doing so in public can be a risk-filled exercise. Ask carefully, "What is the benefit of updating earnings guidance in private? What special circumstances do we face that outweigh the risks?" And then – if there is a strong reason – make sure to consider the timing of any confirmation and whether events since the initial earnings projection have turned the "confirmation" into a new and material disclosure.

"Curing" Unintentional Disclosures

Unintentional disclosures will happen. When they occur, the company should promptly disseminate the disclosed material nonpublic information through a press release or through appropriate website disclosure. The company may also wish to include the curative press release in a current report on Form 8-K. Form 8-K includes a Regulation FD item, Item 7.01, designed precisely to "furnish" rather than "file" the information under Regulation FD. Issuers can use Item 7.01 – not Item 8.01, which is a "filing" – as a "super-press release" to ensure broad dissemination of the relevant information.

Trap for the Unwary: Silence and a Poker Face Are Golden



In its most subtle of Regulation FD enforcement actions, the SEC fined Schering-Plough Corporation \$1,000,000, and its former CEO, Richard Kogan, \$50,000, for both verbal and *nonverbal* selective disclosure of material nonpublic earnings information.

Schering manufactures Claritin[®], a successful allergy drug that was facing the loss of patent protection in 2002. Schering had warned investors that loss of patent protection might have a significant impact on sales.

On September 30, 2002, Mr. Kogan and senior executives learned some bad news: internal earnings forecasts were significantly lower than both Wall Street analysts' consensus estimates and Schering's own published 2002 earnings guidance. Later that day and the next day – weeks before Schering's scheduled release of third quarter earnings – Mr. Kogan and his IRO met in private meetings with analysts and four institutional investors, including three of Schering's largest shareholders.

Mr. Kogan did not make a formal presentation at the meetings. Instead, in a Q&A, he made new and detailed statements about Schering's plans. As the SEC described it, Mr. Kogan was "downbeat" and said that the company would take a "hard hit" to earnings and that 2003 would be a "very, very difficult" and "tough" year, in part, due to the loss of the Claritin[®] patent.

Immediately following the meetings, two analysts downgraded their ratings of Schering's stock. In the three days following the first meetings, Schering's average daily trading volume quadrupled and its share price fell by over 17%. Sales by two of the institutional shareholders who participated in the meetings accounted for over 30% of the trading volume.



Trap for the Unwary: Silence and a Poker Face Are Golden (Cont'd)

Three days later on October 3, 2003, at a private meeting with a larger group of analysts and portfolio managers, Mr. Kogan reiterated many of his September 30 statements, before Schering released earnings guidance for 2002 and 2003 later that day.

The SEC based its enforcement action on this meeting, using it to warn that “[i]ssuers may not evade the public disclosure requirements of Regulation FD by using ‘code’ words or ‘winks and nods’ to convey material nonpublic information during private conversations.”

The SEC focused on Mr. Kogan’s downbeat nonverbal cues, stating that Mr. Kogan disclosed “negative and material, nonpublic information regarding Schering’s earnings prospects” at each of the private meetings “through a combination of spoken language, tone, emphasis, and demeanor.” The SEC’s order described participants’ reactions to Mr. Kogan’s negative tone and “downbeat” demeanor at the meetings.

Lessons Learned?

- Your mother was right. It’s how you say it, not just what you say, that counts. The SEC will read emphasis, tone and body language in assessing disclosure of material nonpublic information.
- The SEC will have the luxury of judging the impact of nonverbal cues with 20-20 hindsight.
- A poker face is golden.

What’s Material? Is It Just “Market Moving”?

Regulation FD applies only to the disclosure of material nonpublic information. Although Regulation FD does not itself define what constitutes material information, guidance comes directly

from the SEC and the U.S. Supreme Court. Information is material to an investor making an investment decision if “there is a substantial likelihood that a reasonable shareholder will consider it important.” There must be a substantial likelihood that the fact “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” The U.S. Supreme Court has rejected any bright-line test for determining materiality. Materiality with respect to contingent events depends on balancing the probability that the event will occur with the magnitude of the expected event in light of the company’s other activities.

When adopting Regulation FD in 2000, the SEC provided a seven-item checklist of information that a company should review carefully to determine materiality. This list represents some of the best guidance the SEC has provided on what constitutes *material* information. The seven “hot buttons” of materiality are:

- Earnings information – historical results or future estimates;
- Mergers, acquisitions, tender offers, joint ventures and other similar transactions;
- New products or discoveries, or developments concerning customers or suppliers (such as gaining or losing a contract);
- Changes in control and the retirement, resignation or termination of senior management;
- Any change in auditors;
- Events regarding securities, such as defaults in senior securities, splits, dividend changes, or public or private sales of additional securities; and
- Bankruptcy or receivership.

Of these, the most sensitive is *earnings estimates*. Concern over selective disclosure of earnings guidance drove the SEC to adopt Regulation FD.



Trap for the Unwary: The Pause That Refreshes: Ask for a Second Pair of Eyes!

In late 2009, the SEC brought a Regulation FD action against the CFO of American Commercial Lines Inc. (ACL) who, on Saturday, June 16 (near the end of the second quarter), emailed updated earnings information to selected analysts. Just a few days earlier, on Monday, June 11, ACL had released quarterly earnings estimates of \$0.20 per share. Then, on that Saturday, the CFO, who was also ACL's IRO, emailed information from his home to eight analysts, reducing that estimate to around a dime per share. ACL did not release a Form 8-K with the updated information until the end of the day, Monday, June 18, and the analysts' reports resulting from the email led to a significant drop in ACL's stock price before the Form 8-K was filed.

Lessons Learned?

- Ask counsel or a communications officer to review your Regulation FD-sensitive communications, particularly earnings estimates. Here, if the CFO had taken that ounce of prevention, he might have prevented this market-moving Regulation FD error.
- The period from the last few weeks of the fiscal quarter through the announcement of earnings is the most sensitive time for Regulation FD earnings disclosures. Make sure to use extra caution during those periods to avoid any mistakes.

The SEC's other principal statement on materiality is Staff Accounting Bulletin No. 99 (SAB 99). In SAB 99, the SEC sought to put to rest the practice of using certain dollar or percentage thresholds to judge nonmateriality. SAB 99 asked:

[M]ay a registrant or the auditor . . . assume the immateriality of items that fall below a percentage threshold . . . to determine whether amounts and items are material . . . ?

The SEC answered with a resounding “No.” Why? Qualitative factors can cause misstatements of even small amounts to be material.

In SAB 99, the SEC gave these examples of issues that might cause information to be material regardless of the dollar amount involved:

- Does it mask a change in earnings or forward-looking trends?
- Was it capable of precise measurement?
- Does it hide a failure to meet analysts’ consensus earnings estimates?
- Would it change a loss into an income item or vice versa?
- Does it touch upon a segment or an aspect of the issuer’s business that plays a significant role in operations or profitability?
- Would it affect the company’s compliance with regulatory requirements?
- Does it affect the issuer’s compliance with debt covenants or other significant contracts?
- Does it conceal an unlawful transaction?
- Would it have the effect of increasing management compensation, for example, by satisfying a bonus or option-vesting threshold?

Practical Tip:
**Use a “Rule of Thumb”
Test as a Starting Point**



In SAB 99, the SEC acknowledges that there still may be a role for a “rule of thumb” test such as 5%, but only as an initial test of materiality. As a member of your company’s Disclosure Practices Committee, you may find this test useful as a starting point. But any percentage threshold can only be a first step toward answering:

Is there a substantial likelihood that a reasonable person would consider this to be important?

SAB 99 notes that stock price volatility is one indicator of materiality. SEC enforcement actions demonstrate that the SEC will assess materiality in hindsight by looking at a company's stock price and trading volume in the period immediately following a selective disclosure of nonpublic information.



Practical Tip:
“Follow the Script”

During Siebel Systems, Inc.'s scheduled public earnings call on October 17, 2001, its then CEO, Thomas Siebel, stated that the market for information technology products had been soft and that he expected it to remain soft through the end of 2001. On November 5, 2001, the CEO participated in an invitation-only technology conference that Goldman Sachs organized for analysts and institutional shareholders. Siebel's investor relations director prepared talking points for the CEO but none regarding the current state of the IT or software market.

By the time of the Goldman Sachs conference, the CEO knew some good news: Siebel's sales were improving. At the conference when asked about the current state of the software market, Mr. Siebel stated that he was “optimistic” and “seeing a return to normal behavior in IT buying patterns.” The conference was not webcast, and the company did not disclose the CEO's statements via a press release or Form 8-K.

Mr. Siebel's avid listeners wasted no time trading in the company's stock. Siebel's stock price and trading volume increased significantly during the conference and increased even more before the CEO's statements reached the media later that day.

According to the SEC, Siebel violated Regulation FD because the conference was not open to the public and the disclosures made by the CEO at the conference were material. The SEC determined the disclosures were material because:

- The disclosures related to *trends* in the company's business;

Practical Tip:
“Follow the Script”(Cont’d)



- The new statement *contrasted with* public statements made on the company’s earnings call; and
- The comments prompted *trading* by attendees at the conference.

Practical Tips?

- Prior to presenting at an analyst conference, disclose material nonpublic information that you wish to be free to discuss in a press release or Form 8-K.
- Arrange for (and pre-announce) a webcast of the company’s presentation.
- Have your IRO or CFO listen for and help your CEO decline to answer “unscripted” questions that will require disclosure of material nonpublic information.

Website Disclosure Can Satisfy Regulation FD

The SEC in 2008 formally acknowledged that disclosures made on company websites can be adequate for the purposes of Regulation FD public disclosure. The SEC did not amend Regulation FD in its website guidance. Instead, it guided companies to self-assess whether their web presence is sufficiently prominent to constitute broad public dissemination. The SEC offered companies three tests to determine whether the release of information on the company website is *public* for Regulation FD purposes:

- *Recognized Channel for Distribution?* Is the company’s website a recognized channel for distribution of information to the market? What steps has the company taken, if any, to alert the market to its website and disclosure practices? Do investors and market professionals look to its website for this kind of information?
- *Broad Dissemination?* Does the website posting disseminate the information available to the marketplace in

general? The SEC has offered a number of “non-exclusive” factors to consider in assessing “general dissemination.” Most importantly, a company should self-assess whether its past and current web disclosure practices are sufficient to provide for general disclosure through its website. Is the website well designed to lead investors to the disclosures?

- *Time to Absorb?* Did you give investors and the marketplace sufficient time to absorb and react to the information? The length of a reasonable period before information is considered public for Regulation FD purposes depends on the facts and circumstances of the release and the company. According to the SEC, these may include the size and market following of the company, the steps taken to alert investors to information on the website, the nature and complexity of the information, and the efforts made by the company to disseminate the information.

**Practical Tip:
Give “Above the Crease”**

Prominence to Website Disclosure



In the same way that a newspaper places a lead headline “above the crease,” Sun Microsystems, before its acquisition by Oracle, posted investor information in prominent boxes at the top of its investor relations website page – or “above the scroll.” Sun led the way, providing an early example of posting feeds of current headlines using the software dialect really simple syndication (RSS) of a CEO’s blog to alert the market, and of habituating market professionals to turn to its website for current disclosure.

Lessons from leaders in website disclosure, including General Electric, Microsoft, Dell, Google and others, suggest four practical steps:

- *Give Prominent Placement.* Post breaking news prominently, certainly “above the scroll” or at the top of the investor relations page of your website.
- *Spread the News.* Use press releases, SEC filings and earnings calls to point investors to your website for

Practical Tip:
Give “Above the Crease”
Prominence to Website Disclosure (Cont’d)



current disclosure. Encourage market professionals to use RSS feeds that will include headlines, a brief description and a link to the full article.

- *Shout the Bad News.* Be cautious in using website disclosure alone for bad news. Consider using traditional media as well to ensure that the market fully absorbs bad news before a market open or discussion of the news in a nonpublic setting.
- *Be Careful in Linking.* Link with a disclaimer explaining why you provide the link and disclaiming the content. Without a disclaimer, you may have liability for content you explicitly or implicitly endorse or approve.

Use this checklist:

- Has your website become a recognized channel of distribution of previously nonpublic material information?*
- Does posting result in prompt and broad dissemination into the marketplace?*
- Has the market had time to absorb your previously nonpublic material information?*

Exemptions From Regulation FD

Regulation FD applies only to certain communications. Communications exempt from Regulation FD include:

- Discussions with the press. But in practice, most companies treat disclosures to the press as equivalent to disclosure to an analyst. (Some journalists will sign a nondisclosure agreement. Otherwise, make the statements Regulation FD compliant.)
- Ordinary course of business disclosure to customers and suppliers.

- Disclosure made by foreign private issuers. A non-U.S. company qualifies as a foreign private issuer unless more than half of its executives and directors or assets are located in the U.S., or its principal place of business administration is in the U.S.
- Disclosure to persons who owe a duty of trust or confidence to the company (for example, lawyers, bankers, investment bankers assisting with specific transactions and accountants).
- Discussions with persons who agree expressly to maintain the disclosed information in confidence. This express agreement may be either written or verbal and may be made before or after the disclosure. It must be more than an implicit agreement or a mere belief on the issuer's part.
- Communications – such as a road show – made in connection with most 1933 Act registered offerings. Most, but not all, 1933 Act registrations are exempt from Regulation FD. For example, both a shelf offering to employee optionees on Form S-8 and a Form S-3 resale registration statement are fully subject to Regulation FD.



Breaking News: Rating Agencies No Longer Exempt

Since late 2010, the SEC no longer exempts communications with rating agencies from Regulation FD. A cautious registrant will ask a rating agency to sign a nondisclosure agreement prior to sharing confidential information as part of the rating review process.



Practical Tip: Unfurl Your “Disclosure Umbrella”: Lessons From Court’s Action in “Siebel II”

The SEC failed in its initial effort to enforce a Regulation FD action in federal court when, in late 2005, a judge dismissed an enforcement action against Siebel Systems, Inc. In April 2003, in the company's second

Practical Tip:
Unfurl Your “Disclosure Umbrella”:
Lessons From Court’s Action in “Siebel II” (Cont’d)



Regulation FD run-in with the SEC, CEO Thomas Siebel had made public statements that linked the company’s performance to a weak U.S. economy. The SEC claimed that Mr. Siebel’s public statements, on April 4, 23 and 28, were so negative (he described a “tough quarter” with a market “like the apocalypse out there”) that the company CFO’s somewhat more positive statements in one-on-one or small group meetings just a few days later (April 30) were new and materially different. The SEC also sought, and the court rejected, sanctions against a “gatekeeper” – the IRO in charge of Regulation FD enforcement – and for an alleged failure of disclosure controls and procedures as a result of the Regulation FD violation.

The SEC objected to CFO Goldman’s “significantly more positive and up-beat” comments at the private meetings with analysts. These private comments, said the SEC, were materially different and so violated Regulation FD when the company did not make simultaneous public disclosure.

The court disagreed with the SEC’s precise parsing of words, in effect finding that Siebel had created a protective “disclosure umbrella” of previously disclosed public material information. To call CFO Goldman’s private comments materially different, said the court, put too fine a point on moderate differences of tone, tense and tint of comments. In fact, the two officers communicated essentially the same substance, but each in his own personal way. For example, it was not fair to allege a Regulation FD violation for a difference in verb tense: CEO Siebel said “I suspect we’ll see some [software deals] greater than five” million dollars, while CFO Goldman used the present tense to confirm that “there were some \$5,000,000 deals in Siebel’s pipeline.” Your spokespersons’ statements need not be “verbatim.”

Practical Tip:

Unfurl Your “Disclosure Umbrella”: Lessons From Court’s Action in “Siebel II” (Cont’d)



Regulation FD is – and the SEC should be – forgiving of differences in human communication. The three key take-away lessons of Siebel II:

- Create a disclosure umbrella of publicly disclosed material information. Use your 1934 Act filings, earnings releases, blogs, website disclosures and conference calls to form a web of information. Your spokespeople can then speak in their own words under this protective canopy of information.
- Be careful in private meetings with analysts. Discussing earnings-related information privately is a minefield. The SEC is likely to continue to enforce violations from these settings.
- The SEC will again bring actions for failure under 1934 Act Rule 13a-15 disclosure controls and procedures as a result of the Regulation FD violations. And when it does, the SEC is likely to use the disclosure control violation to seek sanctions against IROs and other officers.

Liability for Selective Disclosure

To prevent Regulation FD from having a chilling effect on issuers’ communications to the public, the SEC limited Regulation FD liability:

- An issuer may be liable for knowing and reckless conduct, but not for good faith mistakes in making materiality judgments;
- Regulation FD is not an antifraud rule; and
- Regulation FD does not create private rights of action.

Outside Regulation FD, liabilities imposed under 1934 Act Rule 10b-5 for selective disclosure continue unchanged. For example, an issuer’s failure to make a public disclosure might give rise to liability under a duty to correct or duty to update theory.

Practical Tip:
Avoid the Seven Deadly Regulation FD Sins
(Learn From SEC Enforcement Actions)



A review of the SEC's enforcement actions for violations of Regulation FD yields seven steps to improve your investor relations practices.

- **Use Extreme Caution in Private Conversations With Analysts.** Be particularly cautious when the discussions relate to earnings guidance! Don't initiate one-on-one calls to interpret information for an analyst. If your company needs to clarify a public statement, do it first in a press release, with appropriate website disclosure, or in a Form 8-K. Even a clarification or "pointing out" call to an analyst can move the stock price and appear to be material in hindsight. (In 2010, Office Depot paid a \$1,000,000 penalty after making a series of cautionary calls to analysts six days before filing a Form 8-K discussing the economy's impact on earnings.)
- **Follow the Script!** "Follow the script" when talking to anyone outside your company. Preclearing discussion topics, and drafting "talking points" and a script can help you confine commentary to the identified publicly disclosed information.
- **Internal Communication Is Key.** Discuss selective disclosure issues with your IRO before analyst calls and conferences.
- **Remedy Unintentional Disclosures Promptly.** Expect mistakes – and be ready to correct them. Once you learn of an unintentional disclosure of material nonpublic information, promptly disclose it in a press release or Form 8-K. Don't hesitate to pause mid-call to clarify a statement.
- **Consider Market Reaction in Assessing Materiality.** The SEC may assess materiality in hindsight by looking at changes in stock price and trading



Practical Tip:
Avoid the Seven Deadly Regulation FD Sins
(Learn From SEC Enforcement Actions) (Cont'd)

volume following disclosure. So in predicting materiality ahead of time, ask “How will our stock price react?” Then if the market reacts to disclosure that you initially concluded was immaterial, reevaluate your analysis. Consider making prompt public disclosure.

- **Demonstrate Good Faith by Consulting With Legal Counsel.** In 2001, the SEC declined to take action when Motorola’s spokesperson consulted with legal counsel. The SEC disagreed with Motorola’s call but did not take action because of this good faith effort to comply with Regulation FD. The SEC also suggests that company counsel be present at sensitive meetings, such as between outside directors and shareholder groups.
- **Regulation FD Training.** Implement a training plan – include all spokespersons and IROs and include periodic “refresher” sessions. Consider creating a “response team” composed of company executives, IROs and outside counsel that will be prepared to act when an unintentional disclosure occurs.

Regulation G: GAAP and the Earnings Call

With Regulation G, the SEC set bounds around companies’ use – popular in the late 1990s – of a confusing variety of pro forma data, which the SEC calls *non-GAAP financial measures*. The passage of Sarbanes-Oxley in 2002, gave the SEC the mandate to adopt Regulation G and a parallel Regulation S-K provision that governs only filed documents. The SEC’s requirement that companies furnish earnings data on Form 8-K, as we discuss in Chapter 2, ties Form 8-K disclosure closely to Regulation G.

Regulation G has two principal mandates:

- *Don't Confuse or Mislead.* Companies may not present non-GAAP financial measures in ways that are misleading to investors.
- *Reconcile to GAAP.* Companies must present the most directly comparable GAAP measures and a clearly understandable reconciliation of the GAAP and non-GAAP measures.

A *non-GAAP financial measure* is a numeric measure of either historical or future performance, financial position or cash flow that:

- Excludes amounts included in the comparable GAAP measure; or
- Includes amounts excluded from the comparable GAAP measure.

Companies may use operating and statistical data, such as same-store sales and number of employees. Companies may also continue to use ratios calculated using only GAAP financial measures. The SEC does not consider these measures to be non-GAAP financial measures.

Regulation G covers all public releases of material information that contain a non-GAAP financial measure, whether in writing, orally, telephonically, on blogs or websites, or in a webcast. Its two mandates cover both filed documents and more informal disclosures.

Specific requirements of Regulation G and related rules are:

- *Reconcile to GAAP.* In any release of pro forma data, and usually when incorporating by reference a document that contains pro forma data, present the most directly comparable GAAP information and a reconciliation of the non-GAAP information to the GAAP information.
- *"Furnish" Earnings Releases on Form 8-K.* "Furnish" (a less formal action than "filing") earnings releases (or similar disclosures on a completed fiscal period) to the SEC on Item 7.01 of Form 8-K within four business days after the release.

- *Furnish Before Any Earnings Call.* For an earnings call on a completed fiscal period, furnish the Form 8-K for the related earnings release prior to the call (or furnish a second Form 8-K with the call's contents within four business days after the call).
- *Regulation S-K Requirements for "Filed" Earnings Information.* In any disclosure of non-GAAP financial information that is filed (as opposed to furnished) with the SEC, comply with the stricter Regulation S-K requirements.

**Trap for the Unwary:
Regulation G (and Form 8-K Filing)
Rules Apply to All Public Communications**



While Regulation G and the new requirement to “furnish” earnings information on Form 8-K will have their greatest impact on earnings releases, the Regulation G rules apply to any public communication. This includes press releases, analyst calls and slide shows from investor conferences. Legal, finance and investor relations team members now screen all public communications for non-GAAP information, both to provide appropriate GAAP reconciliation and to consider whether the communication triggers a need to file under Item 2.02 of Form 8-K (“Results of Operations and Financial Condition”).

Regulation G. When publicly disclosing non-GAAP information (whether a formal filing or informal webcast call), provide the required Regulation G reconciliation in the disclosure. For an oral disclosure, you can do this by:

- Posting the Regulation G-required disclosure on your company’s website; and
- Providing the website address during the oral presentation.

The SEC expects companies to present non-GAAP information consistently in their public disclosures, whether filed as part of their periodic reports or not. Be cautious about disclosing non-GAAP financial measures in earnings releases

**Trap for the Unwary:
Regulation G (and Form 8-K Filing)
Rules Apply to All Public Communications (Cont'd)**



or other public disclosures that you are not prepared to include in your Form 10-K or 10-Q filings.

Form 8-K “Furnishing.” Are you making the first public communication of previously nonpublic material information discussing a historic, completed quarter or year whether or not it includes non-GAAP financial information? If so, your company must “furnish” this nonpublic earnings information on Item 2.02 of Form 8-K.

Form 8-K’s Narrow Safe Harbor. Form 8-K has a narrow *safe harbor* exemption that allows an earnings call to proceed promptly after a filed earnings release, without a new Form 8-K filing, *even if the call contains material nonpublic information*. This safe harbor allows a company to disclose new information about a completed earnings period in an oral, telephonic or webcast communication, typically an earnings call, without having to file a transcript of the call in a new Form 8-K filing if:

- The communication complements, and occurs within 48 hours after, a related written release that has been “furnished” on Form 8-K;
- The company pre-announces the earnings call by a widely disseminated press release and makes it broadly accessible to the public by dial-in conference call, webcast, broadcast or similar means; and
- The company posts the financial and other statistical information contained in the communication, and any required Regulation G reconciliation, on the company’s website. (For any new information disclosed on the call, post an audio file of the webcast itself, or written transcript, slides or Q&As.)

The SEC encourages companies to provide access to website postings for at least one year. After a brief period, be sure to “archive” the data with appropriate disclaimers on the investor relations page of your website.

SEC-Filed Documents: Reconciliation to GAAP, Prominence and Explanation

To accompany Regulation G, which applies whenever a company publicly discloses a material non-GAAP financial measure, whether filed or not, the SEC amended Regulation S-K to enhance disclosure in “filed” financial statements. Like Regulation G, Regulation S-K requires that companies reconcile the differences between non-GAAP measures and the most directly comparable GAAP measures. Regulation S-K also requires:

- *Prominence*: Companies must present the comparable GAAP measure with equal or greater prominence than the non-GAAP measure. (For example, headers of earnings releases that contain a non-GAAP number should also contain the comparable GAAP number.)
- *Explanation*: Management must disclose the reasons it believes the non-GAAP measure is useful and, to the extent material, any additional purposes for its use of the non-GAAP measure.

And Regulation S-K prohibits:

- *Other Than EBIT or EBITDA, Measures Excluding Charges or Liabilities Requiring Cash Settlement*. Companies may use earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation and amortization (EBITDA), but otherwise should not use financial measures that exclude charges or liabilities requiring cash settlement.
- *Smoothing*. Companies should not adjust non-GAAP performance measures to smooth nonrecurring or unusual items when the nature of the charge or gain is reasonably likely to recur within two years or a similar charge or gain occurred in the previous two years. However, while a company may not state that an item is nonrecurring, infrequent or unusual when it meets the specified “within two years” criteria, it can produce a non-GAAP financial measure that adjusts for a charge or gain if appropriate, as long as the company does not describe the charge or gain as nonrecurring, infrequent or unusual.

- *Non-GAAP Financial Statements on Face.* Companies should not present non-GAAP financial measures on the face of financial statements (including notes) or pro forma financial statements.
- *Confusingly Similar Titles.* Companies should use titles or descriptions for non-GAAP measures that are clearly different from titles or descriptions used for GAAP financial measures.

Practical Tip:
**How to Conduct a Regulations FD and G
Compliant Earnings Call**



Quarterly earnings calls are the best example of the sort of voluntary disclosures for which the SEC designed Regulations FD and G. Prior to each earnings call, your company should take the following steps:

- *Notice.* Issue a press release or broadly disseminated website notice several days or weeks in advance, notifying the public of the earnings call and webcast. Include a statement that discussion may also cover any material developments occurring after the date of the notice but before the date of the call. Consider using a commercial news service to broadly disseminate the time, date and access information, and post access information on your company's website.
- *Pre-Release.* Announce earnings results by press release or appropriate web disclosure prior to the call itself, and furnish the release on Item 2.02 of Form 8-K ("Results of Operations and Financial Condition") for the purpose of both Regulation FD and Regulation G. Some companies may choose a combination of press release and web disclosure, issuing an *advisory release* that points investors to the full earnings results on their websites. If possible, do this either immediately following the close of market on the day before the call or before the opening of the market on the morning of the call.



Practical Tip: How to Conduct a Regulations FD and G Compliant Earnings Call (Cont'd)

Even for companies with significant after-hours or overseas trading, disclosure 30-60 minutes before the opening of U.S. markets (Nasdaq and the NYSE open at 9:30 a.m. Eastern Time) should be sufficient.

- *Prompt Call.* Conduct your earnings call within 48 hours after the Form 8-K filing. If the call includes new nonpublic material information and occurs more than 48 hours after the related written earnings release is furnished on Form 8-K, furnish a new Form 8-K containing a transcript of the earnings call within four business days after the call.
- *Webcast or Call-In.* The company's investor relations department should arrange access to the call for the investing public, either by allowing listeners to join the conference call on a listen-only basis or via webcast. (Generally, press and analysts will be given call-in access with the ability to ask questions. Others will only be able to listen.)
- *Post Data.* Post all financial and statistical information provided in the call or presentation on the company's website *before* the call. Post any Regulation G-required reconciliations of pro forma data to GAAP.
- *Post New News.* Promptly post an audio file or transcript of any newly disclosed material.
- *Use Overviews.* Use overviews or summaries to present financial information. If an overview stands alone, then take care to mark it as an overview or summary and include additional information about where to locate more detailed information.

Corporate Disclosure Policy: Forward-Looking Disclosure and the Safe Harbor

Section 21E of the 1934 Act, Section 27A of the 1933 Act (both part of the Private Securities Litigation Reform Act of 1995) and Rule 175 under the 1933 Act together provide guidelines for companies disclosing *forward-looking statements* to the investing community. Forward-looking statements are projections, plans, objectives, forecasts and other discussions – whether oral or written – of future operations. These guidelines provide a safe harbor defense to securities litigation challenging forward-looking statements that fail to predict the future accurately.

Written Forward-Looking Statements

Sections 21E and 27A incorporate a case-law concept known as *bespeaks caution*, which provides that a reader or listener needs to take any forward-looking statement in context. If the context provides fair warning of future uncertainties, the reader cannot fairly ignore them. To fall within the safe harbor, the forward-looking statements must be accompanied by:

- Meaningful cautionary language that identifies the forward-looking statements; and
- In the case of written statements, the important factors that could cause actual results to differ materially. Boilerplate disclaimers are insufficient for this purpose.

Practical Tip: Sailing Into the Safe Harbor by Updating Risk Factors



In today's economy, the risks that companies face evolve quickly. Risk factors and other meaningful cautionary statements from last year's or last quarter's Form 10-K or 10-Q (or even from an earlier press release) may be inadequate for the report you are filing today. When preparing to file a new periodic report or press release:

- Review the report or press release to identify its forward-looking statements;



Practical Tip:
**Sailing Into the Safe Harbor by
Updating Risk Factors (Cont'd)**

- Specifically tailor cautionary language to the forward-looking statements, and make the warnings conspicuous (don't bury cautionary language in legal jargon);
- Clearly disclose the assumptions underlying each specific forward-looking statement, and identify a variety of reasons for possible deviation from projected results;
- Describe the existence of a specific risk and its magnitude; and
- Update and revise the statements to remain current, and add any new cautions or risks that your Disclosure Practices Committee, Audit Committee or managers can identify.

Oral Forward-Looking Statements

For oral forward-looking statements, meaningful cautionary language must include a declaration that additional information concerning factors that could cause actual results to vary materially is contained in a readily available written document, such as a recent Form 10-K or 10-Q. As with written forward-looking statements, boilerplate disclaimers are insufficient.

Regulation M-A: Merger and Acquisition Communications

A company in the midst of a business combination transaction – such as a stock-for-stock merger, cash merger or tender offer – will need to file with the SEC many communications that relate to the transaction.

Regulation M-A is a series of rules that fashion safe harbors permitting companies to communicate freely about planned business combination transactions (both before and after a registration statement is filed) so long as the company files its written communications with the SEC.

What communications must a company file with the SEC? Any written communication made in connection with, or that relates to, a business combination transaction that is provided to the public or to persons not a party to the transaction. For example:

- Written materials that are used by parties to the transaction to communicate information about the transaction to the public; or
- Written information about a proposed business combination transaction that is provided to a company's employees generally. In contrast, a company does not need to file:
 - Factual business information that relates solely to ordinary business matters;
 - Internal communications that are provided solely to parties to the transaction; and
 - Oral communications. If, however, a company posts an audio or video clip or slides of a conference call on its website, then Regulation M-A requires it to file a transcript of the recording with the SEC.

Regulation M-A's filing requirement begins with the first public announcement of the transaction and continues until the transaction closes. During that period, written communications produced in connection with the business combination transaction must be filed with the SEC on or before the "date of first use." Each Regulation M-A written communication must include a prominently displayed legend. The legend must:

- Advise investors to read the relevant registration statement, proxy statement or tender offer statement for important information; and
- Direct investors to the SEC's website for copies of the relevant documents.



Practical Tip: **Interplay Between Regulations M-A and FD**

Regulations M-A and FD have overlapping, but slightly different, timing and disclosure requirements. Regulation M-A requires filing of a written, public communication on the “date of first use.” In contrast, Regulation FD requires public disclosure of all material nonpublic communications simultaneously with (and, as a practical matter, prior to) any selective disclosure of the information. When both Regulations M-A and FD apply, use a format that satisfies Regulation M-A, but for timing, follow Regulation FD with a prior or simultaneous filing.

While Regulation M-A has similar requirements for all types of business combination transactions, different rules of Regulation M-A operate to impose these requirements depending on the type of business combination proposed and the role of the company making the filing in the business combination. For example, in a stock-for-stock merger, the acquiring company must file under Rule 425 under the 1933 Act and the target company must file under Rule 14a-12 under the 1934 Act.



Practical Tip: **Develop “Best Practices” for Disclosure**

Most public companies will want to adopt a corporate disclosure policy and investor relations practices that comply with Regulations FD, G and M-A, and that take full advantage of the safe harbor for forward-looking disclosures. A Regulations FD, G and M-A compliant disclosure policy will include some variation of the following elements:

1. General Guidelines

Spokespersons. The company should designate only specified individuals (for example, the chairman, CEO, CFO and IRO) as spokespersons.

Approval of Public Releases. A spokesperson (and when sensitive, counsel) should approve all press releases and scripted communications prior to any public release.

Practical Tip:
Develop “Best Practices” for Disclosure (Cont’d)



2. Determination of Materiality and Need for Disclosure

The spokespersons, with the assistance of company counsel as necessary, will determine whether information is material and whether it needs to be disclosed.

(Here the company can provide applicable examples of material information from the SEC’s checklist that we provide earlier in this chapter.)

3. Use Cautionary Language

State the company’s Regulation FD policy at the beginning of private meetings and set boundaries for discussions, including “off limit” topics, such as statements regarding earnings estimates.

Include appropriate cautionary language in every financial press release and in every prospectus, registration statement, 1934 Act report and every other company statement, oral or written, that contains or may contain forward-looking statements.

4. Earnings Calls

(The policy can outline the procedures we suggest earlier in this chapter for earnings calls that comply with Regulations FD and G.)

5. One-on-One Calls or Meetings

Timing of One-on-One and Limited-Access Conversations. Whenever practicable, the company should limit the timing of conversations with analysts and/or investors to the period following an earnings conference call up until a blackout period.



Practical Tip:
Develop “Best Practices” for Disclosure (Cont’d)

Limited Subject Matter Addressed. The spokespersons should strictly limit their responses in these conversations to elaboration of previously disclosed or generally known information, so as not to disclose any material nonpublic information. Want to discuss something new? OK, but first make it public by issuing a press release before the call!

Conduct of One-on-One and Limited-Access Conversations. Whenever possible, two spokespersons should be present during any one-on-one or limited-access conversation with an analyst or investor. When speaking with an analyst or investor on a one-on-one or limited-access basis, the spokespersons should ensure that the analyst or investor understands that the company does not intend to disclose material information selectively.

6. Do Not Comment on Analyst Projections or Previous Earnings Guidance

The company generally should not comment on or confirm previous earnings guidance or individual analyst projections, nor should it refer to or distribute individual analyst projections. The spokespersons may comment on “street” consensus in giving guidance, but take care to comply with Regulations FD and G.

7. Do Not Comment on Transactions or Unusual Market Activity

Unless required by law, the company should not respond to inquiries regarding potential financings, restructurings, acquisitions, mergers or other transactions or unusual market activity.

8. Interviews With News Media

Treat the media as if communications were subject to Regulation FD.

Practical Tip:
Develop “Best Practices” for Disclosure (Cont’d)



9. Merger and Acquisition Transactions

The company should file any written communication that relates to a business combination transaction under the appropriate rule of Regulation M-A. In order to comply with Regulation FD, the company should file the communication before it publicly discloses the information. Each communication should have an appropriate legend advising investors to read relevant documents on the SEC’s website for important information.

10. Liability for Third-Party Web Comments

A company is responsible for all communications that it makes on its own behalf under Rule 10b-5, including company blogs or electronic investor forums. The company will not be held liable for third-party comments made on its website. For example, when an issuer allows reader comments in response to its CEO blog, it is not liable for the content of those comments.

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Chapter 4

Insider Reporting Obligations and Insider Trading Restrictions; Rule 10b5-1 Trading Plans

Directors, executive officers and significant shareholders of a public company are subject to a number of reporting obligations and trade limitations relating to their ownership of and transactions in the company's securities. Compliance with these rules requires strong procedures for both the company and its insiders. This chapter gives an overview of these reporting requirements and trading limitations and suggests ways in which a public company and its insiders can best comply with them.

Section 16 Reporting Obligations of Directors, Executive Officers and 10% Beneficial Shareholders

Who Is an Insider?

Directors and Officers. Section 16(a) of the 1934 Act requires directors and certain officers of a public company to report their beneficial ownership of and transactions in the company's securities to the SEC and the public. An *officer* for this reporting purpose generally includes the company's executive officers as that term is used in the rules governing proxy statements and other SEC disclosure documents and covers:

- President and principal executive officer;
- Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);
- Principal financial officer;
- Principal accounting officer; and
- Any other person who performs similar policy-making functions for the company.

Section 16 officers also include the controller if there is no principal accounting officer and officers of the company's parent or subsidiaries if those officers perform significant policy-making functions for the company.

More Than 10% Beneficial Shareholders. In addition to directors and officers, persons, including entities, who beneficially own more than 10% of a class of a company's registered securities are subject to Section 16(a) reporting requirements. In determining who is a more than 10% holder, Section 16(a) uses the concept of *beneficial ownership* rather than legal or record ownership. A person's voting or investment power over a security is a key factor in determining beneficial ownership. For example, a person with sole or shared voting or investment power over securities will usually beneficially own the securities for Section 16(a) 10% ownership purposes.

What Do Section 16(a) Insiders Report?

Beneficially Owned Shares. For Section 16(a) insiders, the SEC uses a second beneficial ownership test to determine which holdings and transactions the insider must report. Beneficial ownership for purposes of reporting holdings and transactions to the SEC (and for short-swing profit liability) is based on the insider's *direct or indirect pecuniary interest* in the securities. This test is based on an insider's ability to profit from purchases or sales of securities.

Shares Held by Household Members. An insider is considered to have indirect beneficial ownership of securities held by members of the insider's immediate family sharing the same household. These immediate family household members include grandparents, grandchildren, siblings and in-laws, as well as the insider's spouse, children and parents.

Trust Shares. An insider is considered a beneficial owner of shares in a trust for Section 16 purposes if the insider has or shares investment control over the trust securities and the insider is a:

- Trustee, and either the trustee/insider or a member of the immediate family (whether or not they share the same household) has a pecuniary interest in the trust securities;
- Beneficiary; or
- Settlor, and the settlor/insider has the power to revoke the trust.

Partnership or Corporation Shares. An insider who has control or a controlling influence over a partnership or corporation will generally have beneficial ownership of the securities held by that partnership or corporation.

Derivative Securities. Section 16(a) applies not only to a company's common stock but also to derivative securities. Derivative securities include options, stock appreciation rights, warrants, convertible securities or similar rights with an exercise or conversion privilege at a price related to an equity security. Derivative securities also include third-party contracts: puts, calls, options or other rights to acquire the company's securities that an insider enters into with a person other than the company.

How Does an Insider Report Beneficial Ownership?

Initial Report – Form 3. Upon becoming an insider, an insider initially files a Form 3 with the SEC listing all the insider's holdings of the company's securities, including derivative securities such as stock options. The insider must file a Form 3 within ten calendar days of the triggering event; for example, within ten days after becoming an officer, director or more than 10% shareholder of a public company. The insider must file a Form 3 even if the insider does not have a pecuniary interest in any stock of the company at the time of the filing. Insiders of a newly public company file a Form 3 on the date the company becomes a reporting company under the 1934 Act.

Current Report – Form 4. Generally, any change in an insider's beneficial ownership of the company's securities is reported on a Form 4. Insiders usually must file a Form 4 within two business days after a change in beneficial ownership. This two-day reporting period begins when a transaction is executed, not when it settles.

Practical Tip: When to File Form 4?



If an executive vice president places an order to purchase or sell company securities with a broker on a Monday morning in Los Angeles, she must file the Form 4 with the SEC no later than 10 p.m. Eastern time (7 p.m. Pacific time) on Wednesday. The Form 4 must indicate the officer's total direct and



Practical Tip: When to File Form 4? (Cont'd)

indirect ownership in the company's securities after the reported transaction. In accordance with company compliance procedures discussed later in this chapter, the officer should notify the company compliance officer at least two business days before placing the order to enable the company to begin preparing a Form 4 on the officer's behalf.

The Form 4 two-day filing deadline also applies to any transaction between an insider and the company, including transactions that are exempt from short-swing profit recovery under Rule 16b-3 under the 1934 Act, such as the grant, exercise or conversion of stock options or other derivative securities or the withholding of shares for tax purposes (such as upon vesting of restricted stock units).

The SEC provides short extensions of the two-day filing deadline for transactions under 1934 Act Rule 10b5-1 plans (we describe these plans later in this chapter) and discretionary transactions under employee benefit plans. In these cases, if the insider did not select the date of execution and did not have prior notice of the transaction, the insider may file a Form 4 within two business days after the date the insider is notified of the transaction or the third business day following the transaction, whichever is earlier.

Three transactions are exempt from the two-day filing deadline:

- Gifts;
- Inheritances; and
- Small acquisitions other than from the company that do not exceed in the aggregate \$10,000 in market value within a six-month period, provided the insider makes no nonexempt dispositions during the six months thereafter.

The insider must report these transactions at the end of the company's fiscal year on a Form 5 annual report if they were not voluntarily reported earlier on a Form 4.

Practical Tip: Awards at Hire/Initial Board Election



Officers often receive option grants or other awards at the time of hire and directors at the time of election to the Board. The Form 3 filed upon becoming an insider should report only securities owned *immediately prior* to becoming an insider. Report the awards granted *as a result of* becoming an insider on Form 4. In this situation, the Form 4 would be due before the Form 3, so the better practice is to file the Form 3 and the Form 4 at the same time (within two business days after the grant), even though the Form 3 would not technically be due until ten days after the triggering event.

Insiders are not required to report on Form 4 or 5 transactions that effect only a mere change in the form of the insider's beneficial ownership of securities without changing the insider's pecuniary interest in the securities. For example, a distribution to the insider of securities previously beneficially owned by the insider through an employee benefit plan merely changes the form of the insider's beneficial ownership (from indirect to direct) and is exempt from Forms 4 and 5 reporting requirements. Likewise, a pro rata distribution of securities from a general partnership to its general partners is a mere change in the form of ownership, exempt from Forms 4 and 5 reporting. This *change in form* exemption does not apply to:

- The conversion or exercise of a derivative security (this is reported on a Form 4); or
- A transfer of securities to a person whose holdings are attributed to the insider, such as a gift to a minor child or a transfer to a family trust (this is reported on a Form 5 or earlier on a voluntarily filed Form 4).

Even though a mere change in the form of an insider's beneficial ownership does not in itself trigger a Form 4 or 5 reporting obligation, the insider must reflect the resulting changed ownership in the total direct and indirect beneficial ownership column in the next Form 4 or 5 the insider files.

Acquisitions of company securities in ongoing, tax-conditioned employee benefit plans (for example, a broad-based employee stock

purchase plan or 401(k) plan) generally are also exempt from Section 16(a) reporting. But the insider needs to reflect the changes to her current holdings as a result of those acquisitions in the total beneficial ownership column on all subsequent Forms 4 and 5. By contrast, dispositions of securities acquired under employee benefit plans, as well as transfers into and out of company stock funds in those plans, generally must be reported on Form 4.

Annual Report – Form 5. Insiders must file any required Form 5 within 45 days after the end of the company’s fiscal year. Any person who was an insider at any time during the fiscal year must file a Form 5 unless either the insider had no reportable transactions during the year or had already filed one or more Form 4s during the year covering all transactions required to be reported on a Form 4 or 5. A Form 5 must include all reportable transactions that were exempt from Form 4 reporting and not reported earlier and all holdings or transactions that should have been reported on Form 3 or 4 during the fiscal year but were not.

Consequences of Late Filing: Embarrassment, Publicity and Fines

Civil Penalties. Failure to timely file a Form 3, 4 or 5 can result in substantial penalties to the insider. The SEC can seek fines in judicial enforcement actions of up to \$7,500 for each violation by an individual and up to \$75,000 for corporations and other entities. If the violation includes fraud or deceit or deliberate disregard of a regulatory requirement, the fine can be as much as \$150,000 for an individual and \$725,000 for a corporation. (These amounts are subject to adjustment for inflation.) The SEC can also issue cease-and-desist orders in administrative proceedings against future violations. Failure to file reports also prevents the two-year statute of limitations from running on suits against insiders to recover any profits due to the company under Section 16(b).

Proxy Statement and Form 10-K Disclosure. A public company must disclose by name in its proxy statement any insiders who reported transactions late or failed to file required reports during the fiscal year. In addition, the company must note on the cover of its Form 10-K that the proxy statement discloses late Section 16 reports.

Mandatory Electronic Filing and Website Posting of Beneficial Ownership Reports

Electronic Filing. Insiders must file Section 16 reports electronically. The reports are due by 10 p.m. Eastern time on the filing deadline. Although insiders can file reports directly through

the SEC's online filing system located at the SEC's website (<https://www.onlineforms.edgarfiling.sec.gov/>), it is far more common for companies or third-party service providers to submit Section 16 reports on behalf of insiders, although the insiders remain legally responsible for their individual electronic filing obligations.

Practical Tip:
Apply for EDGAR Codes Early



In order to file electronically, insiders must apply for EDGAR access codes. It can take several days to receive the codes, so be sure not to delay submitting an application until the last minute. Since only one set of codes is permitted for an insider, companies obtaining codes on an insider's behalf should verify that the insider does not already have assigned codes (e.g., if a director is or was also a director or officer of another reporting company). Please visit the following link to generate access codes: <https://www.filermanagement.edgarfiling.sec.gov/>.

Website Posting. Section 16 rules mandate that companies post on their corporate websites all Forms 3, 4 and 5 filed by their insiders and 10% beneficial owners by the end of the business day after the date of filing. Companies must keep the reports posted for at least 12 months. Although companies may post the reports directly, most post by hyperlinking to third-party service providers or to the EDGAR database on the SEC's website. The hyperlink must be directly to the forms or a list of the forms, and the link caption must clearly indicate access to insider Section 16 reports.

Practical Tip:
Hyperlink to www.sec.gov



To easily and efficiently satisfy the website posting requirements, link to the EDGAR database on the SEC's website. The advantage is that the EDGAR link will not require an update each time a new Section 16 report is filed and will capture reports of 10% beneficial owners that your company



**Practical Tip:
Hyperlink to www.sec.gov (Cont'd)**

might not otherwise notice. To create a link to the Section 16 reports for your company, visit the SEC's website at www.sec.gov/edgar/searchedgar/companysearch.html.



**Practical Tip:
Implement Section 16(a) Compliance Procedures**

As a best practice for compliance with Section 16(a) reporting obligations, we suggest that your company implement the following procedures:

- *Require Preclearance.* Require all Section 16 insiders to preclear their transactions (or those of any of their family members sharing their household) with the company's CFO, general counsel or other designated compliance officer at least two business days before they initiate any transaction in the company's equity securities.
- *Broker Interface Procedures.* Establish coordinated procedures with knowledgeable brokers and encourage your insiders to use those brokers to facilitate trading in company securities.
- *Powers of Attorney.* Have each director and officer execute a power of attorney authorizing at least two of the company's officers to sign Forms 4 and 5 on behalf of the director or officer. This written authorization is filed with the SEC, typically as an exhibit to the first report authorizing the power of attorney.

Section 16(b) – Short-Swing Profit Liability

Section 16(b) of the 1934 Act imposes liability on insiders for profits realized on *short-swing trades*: that is, for any profits the insider receives from the purchase and sale (or sale and purchase) of nonexempt registered securities of the company within a period of less than six months. In other words, the insider must be sure that no "matchable" transactions occurred in the six months prior

to the planned transaction and must avoid any matchable transactions in the following six months. The insider is liable for profit realized in either cash or noncash form (such as securities). Under Section 16(b), the company or a shareholder acting on behalf of the company may bring an action against the insider for disgorgement of the realized profit. Section 16(b) applies to all Section 16(a) insiders (i.e., directors, executive officers and more than 10% beneficial shareholders).

The test for Section 16(b) liability is purely objective: an insider who purchases and sells (or sells and purchases) nonexempt registered securities within a period of less than six months is liable for the profits received as a result of the transactions. It does not matter whether the insider was aware of confidential information, whether the confidential information was material, whether the insider relied on the information in making the transaction or whether the insider acted in good or bad faith.

Trap for the Unwary: Indirect Ownership



Insiders can be liable under Section 16(b) for transactions in nonexempt shares that they hold indirectly as well as directly – particularly for shares held by household members.

An insider is presumed to have *indirect beneficial ownership* of securities held by members of the insider's immediate family sharing the same household, including the insider's spouse, children, parents, grandparents, grandchildren, siblings and in-laws. As a result, if an insider's spouse or relative living with the insider sells the company's stock, and the insider then purchases lower-priced shares within six months of the sale, the insider is liable for short-swing profits.

This is true even if the insider was not aware that the insider's spouse or household-sharing relative had sold the shares. Liability follows from the insider being presumed to have beneficial ownership of the shares held by the spouse or relative. This is a rebuttable presumption, and the insider may disclaim beneficial ownership of the spouse's or relative's securities in the insider's Section 16 filings.

Transactions Exempt From Section 16(b) Liability

Transactions Between the Company and Its Officers or Directors. Transactions between the company and its officers or directors may be exempt from Section 16(b) short-swing liability. For example, a grant of stock options to a director will not be treated as a purchase under Rule 16b-3, if the company's Board, a committee of nonemployee directors or the shareholders approve the grant, or if the director holds the stock options or shares acquired upon exercise of the stock options for at least six months from the stock option grant date. The director's exercise of the stock options will also be exempt. Similarly, a director's sale or disposition of securities back to the company generally will not be treated as a sale for purposes of Section 16(b) if the Board or a committee of non-employee directors approves the sale or disposition.

Stock Options and Other Derivative Securities: Purchase Occurs at Time of Grant. Shares subject to stock options and other types of derivative securities are deemed to be *purchased* for Section 16(b) purposes upon the grant of the stock option or other acquisition of the derivative security rather than upon exercise or conversion. This is because a derivative security is treated as the functional equivalent of the underlying security into which it can be exercised or converted. For example, the grant of an option to purchase common stock is treated as the functional equivalent of the insider's purchase of the common stock. The exercise, conversion or vesting of a derivative security is generally exempt from Section 16(b) liability.

Although exempt from Section 16(b) liability, insiders must report separately the grant and the exercise or conversion of an option or other derivative security on Form 4 within two business days after each transaction.

Calculating Profit Realized in a Short-Swing Transaction

When applying Section 16(b) to a single purchase and single sale of securities within a six-month period, the profit calculation is straightforward: the aggregate purchase price of the securities is subtracted from the aggregate sale price.

For multiple sales and purchases within a six-month period, the profit realized is calculated under the lowest-in, highest-out method. The following example illustrates the application of the rule:

Assume that Director Bertrand Brass purchases 100 shares of his company's common stock in January for \$40 a share, purchases an additional 100 shares in February for \$45 a share, sells 100 shares in March for \$60 a share, purchases 100 shares in April for \$50 a share, sells 100 shares in May for \$55 a share and sells 100 shares in June for \$80 a share. Under the lowest-in, highest-out approach, the January purchase (\$40 per share) would be matched with the June sale (\$80 per share), the February purchase (\$45 per share) would be matched with the March sale (\$60 per share) and the April purchase (\$50 per share) would be matched with the May sale (\$55 per share). Mr. Brass would be liable for \$6,000 in realized profits.

**Trap for the Unwary:
The Six-Month Shadow –
Continuing Obligations and Liability
of Former Directors and Officers**



Former directors and officers continue to have Section 16(a) reporting obligations (and Section 16(b) short-swing profit liability) for nonexempt trades that they make after termination, if the trade occurs within six months of a non-exempt opposite-way transaction (e.g., open market purchase vs. sale) that the insider effected before termination. The former insider must report these post-termination, opposite-way transactions on a Form 4 (indicating a short-swing violation).

Former directors or officers who did not engage in any transactions during their last six months in office have no Form 4 reporting obligations after termination of service. However, no later than 45 days after the end of the fiscal year in which the director or officer ceased service, she is required to report on Form 5 any exempt transactions (such as gifts) that occurred while she was still an insider and that were not reported earlier. It is a "best practice" for companies to obtain from departing directors and officers who have no Form 5 reportable transactions a representation at the time of their departure that no Form 5 is due. On any Form 4 or 5 filed after termination of service, former directors and officers must check the "exit" box indicating that their insider status has terminated.

Schedules 13D and 13G Reporting Requirements for 5% Shareholders

Entirely apart from any Section 16(a) reporting obligations they may have, shareholders who beneficially own more than 5% of a public company's stock must report their stock ownership to the SEC on Schedule 13D or 13G. Schedules 13D and 13G are frequently filed by a group of shareholders who through shared control or other similar relationship beneficially own in excess of 5% of a public company's stock.

Initial Schedule 13G Report

Within 45 days following the end of the calendar year in which a company completes its IPO, every person (including directors and officers) that beneficially owned more than 5% of the company's stock at the time of the IPO must report that ownership to the SEC on a short-form Schedule 13G. The term *person* includes entities. These initial 5% shareholders are referred to as *exempt shareholders* because their shares were acquired prior to the company's IPO.

Schedule 13D or 13G Filings Once the Company Is Public

After a company is public, any exempt shareholder who acquires more than 2% of the company's stock in a 12-month period, or any other shareholder who acquires 5% or more of the company's stock (following its IPO), may be required to file a Schedule 13D, which is more lengthy than Schedule 13G. Shareholders who are *passive investors* can file or continue to file reports on Schedule 13G, avoiding the more burdensome Schedule 13D. A passive investor is a shareholder who beneficially owns less than 20% of the company's common stock, provided the investor did not acquire the securities for the purpose, or with the effect, of changing or influencing control of the company. A person in a control position – such as a director or executive officer – will not qualify as a passive investor.

In general, an investor must amend Schedule 13G annually to show any changes in beneficial ownership. Whenever a passive investor acquires greater than 10% of the company's stock, the investor must amend the Schedule 13G "promptly" after the date of

the acquisition. From then on, the passive investor must file an amended Schedule 13G promptly after the date on which its beneficial ownership increases or decreases by more than 5%. A nonpassive investor must amend its more detailed Schedule 13D promptly to show any change of 1% or more in beneficial ownership.

A passive investor loses Schedule 13G eligibility – and must file a Schedule 13D – if the investor acquires 20% or more of a class of securities or no longer passively holds the shares. In either case, the investor must file a Schedule 13D within ten days of the acquisition or change in status. The investor may not vote the shares or acquire more shares during the period that begins at the time of the change in investment purpose or the acquisition of 20% or more of the company's shares and ends ten days after the Schedule 13D is filed. The Schedule 13G or 13D filer is obligated to file copies of the reports with the company.

Rule 144 Restrictions on Trading Restricted Stock and Stock Held by Directors, Executive Officers and Other Affiliates

The 1933 Act requires that a sale of a security be registered with the SEC, unless the security or transaction qualifies for an exemption. Rule 144 under the 1933 Act provides the most frequently used exemption for the resale of *restricted* and *control* securities in the public market.

Although brokerage firms generally play the primary role in assisting their clients with Rule 144 compliance, it is a best practice for companies to alert persons subject to Rule 144 to the resale limitations, and to assist with compliant Rule 144 resales. (See our Practical Tip later in this chapter, which includes our suggestions for compliance with Rule 144.)

Securities Subject to Rule 144

Rule 144 covers two types of securities: restricted securities and control securities.

- *Restricted securities* are generally securities that have been issued in a private placement exempt from registration. A stock certificate evidencing restricted securities typically bears a restrictive legend which states that the securities

are not registered and cannot be offered or sold unless they are registered with the SEC or the transaction is exempt from registration.

- *Control securities* are securities owned by any person who directly or indirectly controls the issuer, either alone or as a member of a control group. Control securities may be acquired in any manner, including on the open market, from the company through a public offering or upon the exercise of a stock option. The SEC uses the term *affiliate* to describe such a control person.

Who Are Affiliates?

Since Rule 144 imposes significantly fewer restrictions on the resale of restricted securities by non-affiliates, understanding the distinction between affiliates and non-affiliates is important to understand. Under Rule 144, *affiliates* generally are directors, executive officers and significant shareholders of a company that can influence the company either individually or in concert with others. Other persons generally considered affiliates under Rule 144 are:

- The spouse or any relative of the affiliate who lives in the same household as the affiliate;
- Certain trusts or estates of which the affiliate (or a member of the affiliate's family sharing the same household) is a trustee, executor or 10% beneficiary;
- Certain corporations, partnerships or other entities in which the affiliate or the affiliate's family owns a 10% interest; and
- Affiliates of companies acquired in Rule 145 transactions even if they do not become affiliates of the acquiring company.

Under Rule 144, *non-affiliates* are simply those persons who, after a fact-specific inquiry, are determined not to be affiliates.

Rule 144 Requirements for Both Affiliates and Non-Affiliates

Both affiliates and non-affiliates who sell securities without registration must comply with the following two Rule 144 requirements:

- *Current Public Information.* Adequate public information must be available concerning the issuer of the securities.

A company that has been a reporting company for at least 90 days before the sale must have filed all SEC-required reports during the 12 months immediately preceding the proposed sale (or such shorter period that it was required to file) other than Current Reports on Form 8-K. In addition, the company must have filed electronically and posted on its website, if any, all interactive data files it was required to submit and post during the 12 months immediately preceding the sale (or such shorter period that it was required to file and post the files). (We discuss interactive data files in Chapter 2.)

- *Holding Period for Restricted Securities.* Affiliates and non-affiliates of a reporting company must hold restricted securities for at least six months. Tacking of holding periods is permitted in certain situations (e.g., if the shares were acquired from a non-affiliate). The time period does not begin to run until the seller has fully paid the purchase price for the securities. For example, if the stock was purchased with a promissory note, the note must be full recourse and must be secured by collateral, other than the stock, having at least equal value to the shares to start the holding period. The note must also be paid in full before the stock is sold. Control securities have no holding period.

For non-affiliates who sell restricted securities, the current public information requirement lapses after the securities have been held for one year, and non-affiliates who were not affiliates during the three months preceding the sale can then make unlimited resales of those securities under Rule 144. Affiliates, however, must continue to comply with the current public information requirement as well as the additional requirements listed below.

Other Rule 144 Requirements for Affiliates

The following summarizes the three additional requirements of Rule 144 that apply only to affiliates:

- *Volume Limitations.* Affiliates are limited to selling a number of restricted and control securities during any three-month period that is no more than the greater of 1% of the outstanding securities of the class or the average weekly

reported trading volume for the previous four calendar weeks. (For most insiders, this is a generous cap that does not limit sales.) An alternate volume limitation exists with respect to debt securities, which limits the sale of debt securities to 10% of the outstanding tranche (or class).

- *Manner of Sale.* Restricted or control securities must be sold in unsolicited broker transactions, transactions directly with a market maker or in riskless principal transactions. A *riskless principal* transaction occurs where, after having received an order to buy (or sell), a broker or dealer buys (or sells) the security as principal in the market to satisfy the order to buy (or sell). The seller may not solicit or arrange for the solicitation of orders to buy the stock or make any payment in connection with the sale of the stock to any person other than ordinary commissions payable to the broker who executes the order to sell the stock. In a broker transaction, the broker must do no more than execute the order to sell the stock and receive no more than the usual and customary broker commission. The broker must neither solicit nor arrange for the solicitation of customers' orders to buy the stock. (Most national brokerage firms have a Rule 144 sales unit that will ensure compliance with this manner of sale requirement.) The manner of sale restriction does not apply to debt securities.
- *Notice of Sale.* If in any three-month period the seller intends to sell more than 5,000 shares or expects to receive aggregate sale proceeds of over \$50,000, the seller must file a Form 144, "Notice of Proposed Sale of Securities," with the SEC concurrently with either the placing with a broker of an order to execute a sale or the execution directly with a market maker of a sale. The person filing the notice must have a bona fide intention to sell the securities referred to in the notice within a reasonable time after filing the notice. The purpose of the filing is to serve as a nonbinding notice to the public that a significant number of additional shares are likely to enter the market. The filing is effective for 90 days. If the seller wishes to extend the selling period or sell additional securities, the seller must file a new Form 144. The seller has the option to submit the Form 144 in paper form to the SEC or electronically. In addition, if such

securities are traded on any national securities exchange, a notice of the filing must also be transmitted to the principal exchange on which such securities are traded.

Rule 144 and Shell Companies

Rule 144 generally may not be relied on for the resale of securities initially issued by current or certain former shell companies, other than a business combination-related shell company.

Rule 144 Compliance Chart for Reporting Companies

AFFILIATE	NON-AFFILIATE (and has not been an affiliate during the three months prior to resale)
<p><u>During six-month holding period:</u></p> <ul style="list-style-type: none"> • No resales under Rule 144 permitted. <p><u>After six-month holding period:</u></p> <ul style="list-style-type: none"> • May resell in accordance with all Rule 144 requirements including: <ul style="list-style-type: none"> ➢ Current public information; ➢ Volume limitations; ➢ Manner of sale requirements for equity securities; and ➢ Notice of Sale – filing of Form 144. 	<p><u>During six-month holding period:</u></p> <ul style="list-style-type: none"> • No resales under Rule 144 permitted. <p><u>After six-month holding period until one year:</u></p> <ul style="list-style-type: none"> • Unlimited public resales under Rule 144, except that the current public information requirement still applies. <p><u>After one-year holding period:</u></p> <ul style="list-style-type: none"> • Unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

Insider Trading and Rule 10b-5

The antifraud provisions contained in Rule 10b-5 under the 1934 Act prohibit directors, officers, employees and others who are aware of material nonpublic information from trading while aware of that information. Disclosing material nonpublic information to others who then trade while aware of that information is also a violation of Rule 10b-5, and both the person who discloses the information and the person who trades while aware of the information are liable. These illegal activities are commonly referred to as *insider trading*. In the context of insider trading, the term *insider* covers all employees and anyone else who is aware of the material nonpublic information, such as consultants, in addition to Section 16 insiders.

Penalties

Insider Liability: For Trading. Potential penalties for insider trading violations include imprisonment for up to 20 years, civil fines of up to three times the profit gained or loss avoided by the insider trading and criminal fines of up to \$5,000,000.

Issuer Liability: For Inaction. The company, as well as directors and officers, may be subject to controlling-person liability under federal securities laws. Controlling-person liability may apply if the company or the director or officer knew, or recklessly disregarded, that a person directly or indirectly under the company's or the responsible person's control was likely to engage in insider trading and the company or person failed to take appropriate steps to prevent the trading. The penalty for inaction is a civil fine of up to the greater of \$1,425,000 (subject to adjustment for inflation) or three times the profit gained or the loss avoided as a result of the insider trading and criminal fines of up to \$25,000,000.

Company Insider Trading Policy

The best way to protect a company and its insiders from potential liability under the insider trading laws is to adopt and enforce a clear policy that defines insider trading and prohibits trading while aware of material nonpublic information. The insider trading policy should apply to all directors, officers, employees and consultants of the company.

Establish Blackout Periods. The policy should establish trading blackout periods. A trading *blackout period* is a time period during which the company prohibits Section 16 insiders and other employees and consultants who have access to material nonpublic information about the company from buying and selling the company's securities. Blackout periods generally begin two to four weeks before the end of the quarter and end after the first or second full business day following the company's earnings release for that quarter. If a material event occurs (or material information is known) outside a blackout period, the company generally will impose an event-specific blackout period for applicable insiders while the event (or information) remains material and nonpublic.

Require Preclearance. Section 16 insiders and certain other employees and consultants with access to material nonpublic information should be required to notify and seek approval from a company compliance officer before any transactions in company stock by them or their family members at least two business days before the contemplated transaction.

Rule 10b5-1 Trading Plans

Rule 10b5-1 provides an affirmative defense for insiders who sell securities pursuant to a previously established Rule 10b5-1 trading plan, even when the insider is aware of material nonpublic information at the time of the actual trade. (We discuss Rule 10b5-1 trading plans in detail later in this chapter.) A company's insider trading policy will generally permit insiders to adopt a Rule 10b5-1 trading plan during a period of time outside a blackout period and when an insider is not aware of material nonpublic information, and only if the plan is precleared by a compliance officer. The insider trading policy should exclude trades under appropriately established Rule 10b5-1 trading plans from the preclearance policy and blackout periods.

Insider Trading During Pension Plan Blackout Periods Prohibited

Under the SEC's Regulation Blackout Trading Restriction (BTR), executive officers and directors may not, during any pension plan blackout period, directly or indirectly (including through a

family member) acquire, sell or transfer any company equity securities that the director or executive officer acquired in connection with employment or service as a director or executive officer.

A Regulation BTR blackout period means any period of more than three consecutive business days during which pension plan participants cannot trade in securities held in their individual accounts, but only if this suspension affects at least 50% of the participants in all of the company's "individual account plans." A Regulation BTR blackout period does not include:

- Any regularly scheduled trading suspension that the company incorporates into the pension plan's governing documents and timely discloses to employees before they become participants; or
- Certain temporary trading suspensions imposed by the pension plan in connection with individuals' becoming (or ceasing to become) participants in the plan by reason of a corporate merger, acquisition or similar transaction.

A variety of transactions over which directors and executive officers have no control fall outside Regulation BTR. For example, transactions under Rule 10b5-1 plans, changes that result from a stock split or dividend and compensatory grants and awards under plans that clearly set out the amount, price and timing of awards or include a formula for determining these items, are all exempt.

To satisfy Regulation BTR and notify the directors, executives and the public, companies must within specific time frames:

- Provide their directors and executive officers with a Regulation BTR notice of pension plan blackout periods; and
- File the Regulation BTR notice on Form 8-K.

Practical Tip:
**Provide Your Directors and Officers
With a Trading Compliance Checklist**



In addition to implementing an insider trading policy and Section 16(a) and Rule 144 compliance procedures, providing your insiders with a Trading Compliance Checklist similar to this will serve as a basic reminder of trading prohibitions and SEC filing requirements:

1. Comply With the Company's Insider Trading Policy

Anytime you engage in a transaction involving company securities, you must comply with the company's insider trading policy and applicable insider trading laws. Our insider trading policy requires that transactions by insiders be pre-cleared with the company's compliance officer and that insiders trade only during periods that are not blackout periods. Before effecting any transaction in company securities, you should ask:

- Is the company in a blackout period?
- Am I aware of any material nonpublic information?
- Have I pre-cleared the transaction with the company's compliance officer?

2. Short-Swing Profit Matching Liability Under Section 16(b) and Reporting Under Section 16(a)

Any nonexempt trade you make that effects a purchase within six months before or after a sale or a sale within six months before or after a purchase results in a violation of Section 16(b). The profit will be determined by matching the highest-priced sale with the lowest-priced purchase within six months of the sale. Even if you do not realize this profit in an economic sense, the company or any shareholder acting on behalf of the company may recover this profit from you. It makes no difference how long you held the shares, that you were not aware of inside information, that you had no harmful intent or that one of the two matchable transactions



Practical Tip:
**Provide Your Directors and Officers
With a Trading Compliance Checklist (Cont'd)**

occurred after you were no longer an insider. Before effecting any transaction in company securities, you should ask:

For Sales:

- Have I, my immediate family members or any trust, partnership or corporation that I am affiliated with made any purchases within the past six months?
- Do I anticipate that I, my immediate family members or any trust, partnership or corporation that I am affiliated with will make any purchases within the next six months?

For Purchases:

- Have I, my immediate family members or any trust, partnership or corporation that I am affiliated with made any sales within the past six months?
- Do I anticipate that I, my immediate family members or any trust, partnership or corporation that I am affiliated with will make any sales (including sales occurring through a broker-assisted cashless option exercise) within the next six months?

Before Any Transaction in Company Securities:

- Have I notified the company's compliance officer at least two business days prior to engaging in the transaction for purposes of facilitating Section 16 filings?

3. Compliance With Rule 144

To comply with Rule 144, certain limitations on sales of company securities must be met and a Form 144 generally must be filed by insiders. Before effecting any transaction in company securities, an insider should ask:

- Has a Form 144 been prepared?
- Have I reminded my broker to sell under Rule 144?

Get With the Program: Rule 10b5-1 Trading Plans

One cost of inside knowledge for a public company director or executive officer is illiquidity. The insider cannot sell shares during a trading blackout period, and never when the insider is aware of material nonpublic information. For many insiders, this may leave little or no time in which to trade. The SEC, by adopting Rule 10b5-1 in 2000, opened a path that can bring transparency and order to insider selling, and so both eases this liquidity squeeze and helps ensure compliance with the antifraud provisions of Rule 10b-5.

Rule 10b5-1 begins by clearly stating that anyone trading in a company's securities while aware of material nonpublic information is engaging in unlawful insider trading. The rule then provides a limited safe harbor (technically, an affirmative defense) that, when closely followed, creates a shield from liability. Rule 10b5-1 allows insiders to adopt (at a time when the insider is not aware of material nonpublic information) a written trading plan that will permit future sales (even when those future sales may occur at times that the insider is aware of material nonpublic information). Rule 10b5-1 trading plans are relatively easy to understand, establish and administer, and recent court cases have demonstrated the usefulness of properly structured plans in defending against charges of insider trading. However, perceived abuses of Rule 10b5-1 trading plans have led to scrutiny by the SEC and the courts.

Benefits to the Company and Its Insiders on Adopting Rule 10b5-1 Trading Plans

In addition to helping establish protection from liability, written Rule 10b5-1 trading plans can:

- Enable insiders to make orderly dispositions of stock for diversification, estate planning or other personal needs, and to facilitate stock option exercise and sale programs;
- Reduce the number of times a company faces a decision about whether material nonpublic information exists that requires the company to prohibit trading in its stock by insiders;

- Help market perceptions by bringing transparency and advance disclosure to insiders' sales of company stock; and
- Protect an insider from the risk of "conduit theory" liability for gifts to charitable organizations or others when the insider knows the donee is likely to sell the gifted securities in the near future.

The Three "Legs" of a Rule 10b5-1 Trading Plan

A successful Rule 10b5-1 trading plan stands on three legs. First, the trading plan must be established when the insider is not aware of material nonpublic information. SEC guidance clarifies that the affirmative defense of a trading plan is not available if an insider establishes the plan while aware of material nonpublic information, even if the plan is structured so that transactions will not begin until after that material information is made public.

Second, the trading plan must be in writing and must:

- Specify the amount (either number of shares or dollar value), price (market price on a particular date, a limit price or a specified dollar price) and dates of the trades (this may be the day on which a market order is to be executed or on which "best execution" begins or on which a limit order is in force); or
- Include a formula, algorithm or computer program for determining the amount, price and dates of the trades to be made; or
- Delegate to another person sole discretion to determine the amount, price and dates of the trades to be made, provided that person is not aware of material nonpublic information.

Third, each trade should comply with the trading plan. The insider must not alter or deviate from the trading plan (by changing the amount, price or timing of the trade) or enter into or alter a corresponding or hedging transaction or position with respect to the securities. SEC guidance clarifies that the cancellation of one or more plan transactions represents an alteration of or deviation from the trading plan that affects the availability of the affirmative defense.

In addition to these three legs, the insider must enter into the trading plan in good faith and not as part of a scheme to evade the prohibitions of Rule 10b5-1. SEC guidance clarifies that in creating a new trading plan after cancelling a prior trading plan, all surrounding facts and circumstances, including the period of time between the cancellation of the old plan and the creation of the new plan, must be evaluated in determining the insider's good faith intent.

Drafting a Rule 10b5-1 Trading Plan

The legal or compliance department of the insider's broker usually will take the lead in drafting the insider's Rule 10b5-1 trading plan. The insider and the company must then closely review and tailor the draft plan to ensure that it fits their requirements. The plan should first establish the amount, price and dates of the trades, or a method to determine the amount, price and dates. Next, a Rule 10b5-1 trading plan will state explicitly in writing that:

- *No Inside Information.* When the insider enters into the trading plan, the insider is not aware of material nonpublic information with respect to the company or its securities.
- *Waiting Periods.* The first transaction under the plan will take place only after a waiting period (at least 30 days to three months from the date the plan is executed). Similarly, there will be waiting periods of at least 30 days before trading can be resumed under a modified plan and before an insider who has terminated a plan can enter into a new plan. These waiting periods help solidify the insider's good faith in establishing the trading plan.
- *No Hedge.* The insider has not entered into or altered a corresponding or hedging transaction with respect to the stock to be traded under the trading plan and agrees not to enter into any of those transactions while the plan is in effect.
- *Rule 144.* The insider and the broker will take any steps necessary to comply with Rule 144.
- *Filings.* The insider will be responsible for making all filings, if applicable, under Sections 13(d) and 16 of the

1934 Act, and the broker will supply the insider with all the information necessary for those filings on a timely basis.

- *Independent Broker.* The insider acknowledges that the insider does not have any authority, influence or control over any actions by the broker and will not attempt to exercise any authority, influence or control, and the broker will not seek advice from the insider with regard to the manner in which the broker acts under the trading plan.
- *Purpose.* The trading plan has a specified purpose, for example, to permit the orderly disposition of a portion of the insider's holdings or to facilitate the exercise of options and sale of the underlying stock.
- *Good Faith.* The insider is entering into the trading plan in good faith and not as part of a plan or scheme to evade the provisions of Rule 10b5-1.
- *Intent.* The trading plan is intended, and will be interpreted, to comply with Rule 10b5-1 and related SEC interpretations.

Review by the Issuer

A company's insider trading policy should require insiders to submit Rule 10b5-1 trading plans to the company's compliance officer for preclearance before adoption. The purpose of preclearance is not for company "approval" of the terms of the trading plan, but to permit the compliance officer to determine that the plan is being adopted outside a trading blackout period and otherwise complies with the company's insider trading policy. To assist with this review, companies should consider adopting written Rule 10b5-1 guidelines that all insiders must follow in adopting a Rule 10b5-1 trading plan.

Public Disclosure; Filing the Right Forms

If the Rule 10b5-1 trading plan relates to a senior executive and a material number of shares, the company should consider disclosing the establishment of the executive's trading plan in order to maximize transparency, preempt market reaction and alleviate

shareholder concerns. A company can make the public disclosure through one or some combination of a Form 8-K, Form 10-Q, press release or website posting.

Companies should implement procedures to ensure that insiders timely report Rule 10b5-1 trading plan transactions on Forms 4, 5, 144 and, as required, Schedule 13D or 13G. When reporting transactions on Form 144 (initially filed when the first trade under the trading plan is executed or a sell order is placed), the insider must indicate in the space provided below the signature line the date on which the insider adopted the trading plan and sign the form, which actions serve as the insider's representation that the insider was not aware of material nonpublic information as of the date the plan was adopted (rather than the date the Form 144 was signed). Sales under a trading plan that will occur over more than three months will require multiple Form 144s. In the Form 4 to report the transaction, insiders should also note that the trade was pursuant to a Rule 10b5-1 trading plan.

Practical Tip: Six Simple Steps



Insiders should be cautioned that a Rule 10b5-1 trading plan, even one that meets all the requirements of Rule 10b5-1, only provides an affirmative defense in an enforcement action or lawsuit alleging unlawful insider trading. It does not prohibit someone from bringing the enforcement action or lawsuit. Insiders can strengthen this affirmative defense by following the six steps suggested below.

- Ask the broker that will be executing the insider's trades for a copy of the broker's current form of a Rule 10b5-1 trading plan. This will be the starting place for drafting a trading plan. The company's counsel or a compliance officer should then review the draft for compliance with the company's insider trading policy and to ensure that the plan protects the company's interests.
- An insider can terminate a trading plan. But do it with caution. Termination may call into question whether the plan was entered into in good faith and



Practical Tip: Six Simple Steps (Cont'd)

not as part of an effort to evade insider trading rules. If an insider terminates a trading plan, she should observe a waiting period before entering into a new plan.

- An insider may modify a trading plan, provided that the insider is not aware of material nonpublic information at the time of the modification. But any modification is, in effect, creating a new trading plan and a waiting period should be imposed before effectiveness of the modification. Frequent modifications, like terminations, can call into question the good faith of the insider.
- An insider may make trades outside the trading plan provided the insider is not aware of material nonpublic information. Trades outside the trading plan are not protected by Rule 10b5-1's affirmative defense and must not hedge trades made under the plan.
- Carefully review the insider's contractual lock-up agreements. Underwriters, for example, may have prohibited or restricted any trades for a set period after an offering.
- A trading plan should provide for automatic suspension or termination upon specified events. These may include the insider's death or bankruptcy, imposition of an underwriter's lock-up or the announcement of a tender offer for the company's stock or a merger.

Chapter 5

Proxy Solicitation and the Annual Report to Shareholders

The Proxy Statement

Prior to each shareholders' meeting, a public company solicits a proxy from each of its shareholders by providing a proxy statement and a proxy card (or voting instructions). A *proxy* is a power of attorney allowing the company's management (or another designee) to vote the shares owned by a shareholder as directed by the shareholder or at the designee's discretion. The *proxy statement* informs shareholders about the items of business to be voted on at a shareholders' meeting and solicits a proxy from each shareholder. The proxy solicitation process allows shareholders to exercise their voting rights without being physically present at the shareholders' meeting.

The Annual Meeting of Shareholders

In connection with a public company's annual meeting of shareholders, a public company provides its shareholders with a proxy statement and an annual report to shareholders, which together play a critical role:

- They provide an annual, formal communication from management to the company's shareholders; and
- They serve as an annual corporate governance check-up.

Special Shareholders' Meetings

A public company may also hold a special meeting of shareholders for a variety of reasons, including seeking shareholder approval for mergers or other transactions involving an acquisition

of the company. In connection with these special meetings, a company provides its shareholders with a proxy statement, which contains some of the same information that is included in the proxy statement distributed to shareholders in connection with the annual meeting.

Regulations Governing the Proxy Statement

Regulation 14A of the 1934 Act governs any communication by a public company reasonably calculated to cause a shareholder to grant, withhold or revoke a proxy. Regulation 14A requires a public company to disclose material information and prohibits fraud in connection with a proxy solicitation. State corporate law, as well as the provisions of each company's certificate or articles of incorporation and bylaws, also governs aspects of the proxy solicitation process.

Information Included in the Proxy Statement

Schedule 14A outlines the information that a public company must include in a proxy statement. This required information goes well beyond issues that relate strictly to electing directors. Companies typically include, for example, many Form 10-K–required disclosures in the proxy statement, and incorporate them by reference into the Form 10-K. (Form 10-K permits this so long as the company files its proxy statement within 120 days after its fiscal year-end.) Mandatory Schedule 14A disclosures include:

- *The Meeting.* The date, time and location of the shareholders' meeting.
- *Voting Information.* A description of the shareholder vote required for approval of each matter to be voted on at the shareholders' meeting, the record date for determining the holders of shares entitled to be voted and the method for counting votes.
- *Board Elections.* Detailed background information about the director nominees and incumbent directors.
- *Executive Compensation.* Detailed tabular and narrative information about the company's compensation for its principal executive officer, principal financial officer and three other most highly compensated executive officers

(the *named executive officers*), as well as discussion and analysis of how and why the company decided to pay the types and amounts of compensation paid for the last completed fiscal year.

- *Say-on-Pay Proposals*. A nonbinding shareholder vote on the compensation disclosed for the company's named executive officers (required every one, two or three years) and a separate nonbinding vote (at least every six years) on how frequently to hold the Say-on-Pay vote.
- *Related Transactions*. A description of any material transactions between the company and any director, director nominee, executive officer or 5% shareholder, or any of their immediate family members, and the company's procedures for approving these types of transactions.
- *Corporate Governance*. Detailed information regarding director independence, committee governance and composition, director compensation, the Board nomination process and Board leadership structure.
- *Risk Management*. The Board's role in risk oversight and the company's risk management for any material compensation-related risks.
- *Beneficial Ownership and Section 16 Compliance*. The identity of shareholders who beneficially own 5% or more of the company's shares, the share ownership of the company's directors, named executive officers, and directors and all executive officers as a group, and any failures by these persons to comply with the reporting requirements of Section 16(a) of the 1934 Act.
- *Equity Compensation Plans*. If the company is seeking shareholder approval of any compensation plan, information about all company equity compensation plans, plus narrative descriptions of any plans that had not been approved by the company's shareholders.
- *E-Proxy Disclosures*. How to access the company's proxy materials online.



Breaking News: The Dodd-Frank Act Significantly Impacts Proxy Voting and Proxy Statement Disclosures

The Dodd-Frank Act, which became law in 2010, significantly impacts proxy voting and proxy statement disclosures. Major changes imposed by the Dodd-Frank Act include:

- Requiring nonbinding shareholder votes on executive compensation at least every three years and on the frequency of the vote on executive compensation at least every six years.
- Eliminating discretionary voting by brokers on executive compensation and other matters.
- New independence requirements and considerations for compensation committees and their advisors and related disclosures.
- Mandatory clawback of some executive incentive compensation.
- New disclosure of company policies on hedging of company securities by directors or employees.
- New disclosure on the relationship between executive pay and company performance.
- New disclosure on the ratio of median employee pay to chief executive officer pay.
- Authorization for SEC to implement proxy access.

Only the first two provisions were in effect when this Handbook went to press at the end of 2011. The others require further SEC and NYSE/Nasdaq rulemaking.

Executive Compensation

Compensation Discussion and Analysis (CD&A). Companies begin their executive compensation disclosure with the CD&A, which discusses the material information necessary to understand the objectives of a company's compensation for its named executive officers for the last-completed fiscal year. The CD&A is principles-based, similar to the MD&A in the Form 10-K. This means that each company must determine, in light of its particular facts and circumstances, what elements of the company's compensation policies and decisions are material to investors' understanding. In addition, the CD&A answers these questions:

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and any formula) for each element?
- How do each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?
- Whether, and if so, how did the company consider the results of the most recent Say-on-Pay vote in determining compensation policies and decisions?

The SEC rules also provide a nonexclusive list of topics a company should address in the CD&A to the extent material to an understanding of its compensation for its named executive officers for the last year.

A Compensation Committee Report, which accompanies the CD&A, confirms that the Committee has reviewed and discussed the CD&A with management, and recommended to the Board that the CD&A be included in the proxy statement.



Practical Tip: Aim Carefully! Disclose Performance Targets

Your company must generally disclose company and individual performance targets for incentive compensation as well as the actual achievement levels against the targets. You will need to include these targets if they are material elements of your company's compensation policies and decisions, unless you can demonstrate that the disclosure would result in competitive harm to the company. You will find that the SEC, through comment letters, will impose a stringent standard of review on omitted performance goals. It rarely accepts "competitive harm" arguments for corporate-level financial performance targets for completed fiscal periods. If your company omits performance targets, discuss in your CD&A with meaningful specificity how difficult it will be to achieve the undisclosed targets.

Executive Compensation Tables and Related Narrative Disclosures. A series of required tables and supplemental narrative disclosures follow the CD&A, showing compensation of named executive officers in three categories:

- All compensation paid, earned or awarded in the most recently completed fiscal year and the two preceding fiscal years, with a specific breakdown of equity and nonequity plan-based awards during the last-completed fiscal year;
- Current equity holdings and realizations on equity awards; and
- Post-employment compensation, including pension plans, nonqualified deferred compensation and other plans and benefits, including payments relating to severance, retirement and change of control.

Narrative disclosure will provide the context for these compensation tables. By contrast, the narrative in the CD&A focuses on the broader issues of the "how" and "why" of compensation policies and programs.

Analysis of Risk Related to Compensation for All Employees

Risk now requires specific CD&A discussion. Companies are to discuss and analyze compensation policies and practices for all employees to the extent that the policies or practices create risks that are reasonably likely to have a material adverse effect on the company.

Practical Tip: Look Out! Disclose Process and Conclusions Regarding Risk Analysis



The proxy disclosure rules do not require you to state that your company has determined that the risks arising from your compensation policies and practices are not reasonably likely to have a material adverse effect on your company. However, consider this: affirm both your risk analysis conclusion and the process by which you arrived at that conclusion. If you do this, discuss the policies or practices (such as clawbacks or minimum stock ownership guidelines) that mitigate those risks that your incentive compensation programs create. If you discuss these risk-mitigation elements, set them off under a separate, identifiable heading to make clear that you are not including these elements in the executive compensation covered by the Say-on-Pay vote. You should also consider including details regarding the consideration of risk for named executive officer compensation policies and practices within the CD&A.

Say-on-Pay and Say-on-Frequency

Since 2011, public companies holding a shareholders' meeting to elect directors also conduct nonbinding, advisory votes on both the compensation paid to named executive officers (the *Say-on-Pay* vote) and, at least once every six years, whether the Say-on-Pay vote should be held every one, two or three calendar years (the *Say-on-Frequency* vote). Smaller reporting companies are not to hold these votes until 2013.

Say-on-Pay Vote. The Say-on-Pay vote seeks approval of executive compensation as disclosed in the proxy statement. Although SEC rules require no specific language or form of resolution, generally a company must:

- Indicate that the vote is to approve the compensation of named executive officers as disclosed in the proxy statement, including the CD&A, the compensation tables and the related narrative disclosures;
- Disclose that a Say-on-Pay vote is being presented pursuant to the SEC's proxy rules, and explain the general effect of the vote (i.e., the nonbinding nature of the vote); and
- After the initial Say-on-Pay and Say-on-Frequency votes, disclose in subsequent proxy statements when the next Say-on-Pay and Say-on-Frequency votes will occur.

In addition, companies must disclose in future CD&As how the results of the most recent Say-on-Pay vote have been considered in determining compensation policies and decisions.



Practical Tip: Make Your Best Case for Say-Yes-on-Pay

Drafting your CD&A well will allow it to serve as your company's voice in presenting your executive compensation story to investors. To make the best case for your Say-on-Pay vote, consider:

- Kick off with an executive summary or overview for the CD&A that focuses on the pay-for-performance story.
- Describe key compensation policies, including stock ownership guidelines, clawback policies, perquisite policies and severance and post-retirement benefits. Consider: should you make any changes?
- Engage early and often with investors over executive compensation and corporate governance issues. Communicating with investors is especially important since brokers can no longer vote uninstructed shares with discretion on executive compensation matters, including Say-on-Pay proposals. (We discuss discretionary voting by brokers in Chapter 6.)

Say-on-Frequency Vote. The purpose of the Say-on-Frequency vote is to ask, at least every six years, how often shareholders would prefer future Say-on-Pay votes to occur. The proxy card should give shareholders four alternatives: every one, two or three years or abstain. Companies must disclose that they are providing a separate Say-on-Frequency vote pursuant to the SEC's proxy rules and explain the nonbinding nature of the vote. Although a company's Board may include a recommendation on how shareholders should vote, the proxy statement should be clear that shareholders are not voting to approve or disapprove the Board's recommendation.

Practical Tip:
Preserve Your Discretion to Vote
Uninstructed Say Proxy Cards



When drafting your proxy card, you can carefully preserve your ability to vote uninstructed proxy cards in accordance with management's recommendation for the Say-on-Frequency vote if you:

- Include a recommendation for the frequency of the Say-on-Pay votes in the proxy statement; and
- Include language in bold on the proxy card regarding how management intends to vote uninstructed shares.

Form 8-K Disclosure. Companies disclose the voting results for the Say-on-Pay and Say-on-Frequency votes under Item 5.07 of Form 8-K within four business days following the date of the shareholders' meeting. This may include the Board's decision on how frequently to hold future Say-on-Pay votes, although this decision can also wait until an amendment to that Form 8-K filed within 150 days of the shareholders' meeting or, if earlier, 60 days before the Rule 14a-8 shareholder proposal deadline.

Board and Corporate Governance

SEC disclosure requirements for annual reports and proxy statements highlight the composition and role of the Board and corporate governance generally. Key governance disclosures include:

- ***Director Independence and Meeting Attendance.*** The NYSE and Nasdaq listing standards require a majority of a

listed company's Board to be independent (as defined by the applicable exchange). The company must identify its independent directors in its proxy statement. In addition, all nonmanagement directors must meet in regular executive sessions, and NYSE companies must disclose in the proxy statement the name of the director who presides over these executive sessions. (We discuss NYSE listing standards in Chapter 8 and Nasdaq listing standards in Chapter 9.) A company must also disclose the total number of Board meetings during the last fiscal year and identify directors who attended fewer than 75% of the aggregate of the total number of their Board and committee meetings. A company must also disclose its policy on director attendance at the annual meeting and the number of directors who attended the prior year's annual meeting.

- *Board Leadership Structure and Role in Risk Oversight.* The proxy statement will describe Board leadership structure and explain why the Board believes its chosen structure is most appropriate in light of the nature and current circumstances of the company. In particular, if the roles of CEO and Chairman of the Board are combined and a lead independent director leads meetings of the independent directors, the company must disclose why it has a lead independent director and describe the specific role the lead independent director plays in the leadership of the company. The proxy statement will discuss the Board's role in risk oversight. For example, does the whole Board or a separate risk committee perform risk oversight?
- *Transactions With Related Persons.* The proxy statement provides an annual highlight of any transaction that the Board determined to be a related person transaction or that, although not determined to be a related person transaction, was considered by the Board in determining a director's independence. Companies also describe their policies and procedures for the review and approval or ratification of potential related person transactions.
- *Board Committees.* The proxy statement discloses whether or not the Board has each of the customary standing Board committees, Audit, Nominating & Governance and Compensation Committees (or a committee performing similar

functions). Disclosure identifies the function of each Committee and the directors who serve on each, confirms their independence, discloses whether each Committee has a written charter and where the charter is available. There are also specific disclosures required regarding each Committee, such as whether the Audit Committee includes an Audit Committee financial expert.

- *Compensation Consultants.* The proxy statement also describes the role of compensation consultants in determining or recommending the amount or form of executive and director compensation and report aggregate fees paid to those consultants. To help investors assess any conflicts of interest, companies generally must also disclose additional information if the consultant provides other services to the company resulting in fees greater than \$120,000 during the company's fiscal year.

Breaking News:
**SEC Proposes Dodd-Frank Rules on the
Compensation Committee and Advisor Independence
Provisions**



In 2011, the SEC proposed rules directing the NYSE and Nasdaq to develop listing standards to implement the provisions of the Dodd-Frank Act regarding the independence of Compensation Committee members. New disclosure will also address the authority of the Committee and the Committee's consideration of specific factors relating to the independence of its compensation advisors. The SEC also proposed related proxy statement disclosure rules.

Director Nominations. A detailed description of the director nomination processes in the proxy statement, to give shareholders an understanding of Board operations, will include:

- *"Minimum Qualifications" of Director Candidates.* First, the proxy statement will set out the "minimum qualifications" needed by a director nominee in order to be recommended by the Nominating & Governance Committee. Companies then describe the experience, qualifications, attributes or skills of each director and nominee. The biographical

information includes the other public company and registered investment company Boards on which the director or nominee served during the preceding five years.

- *Shareholder-Recommended Director Candidates.* The proxy statement will describe the policy, if any, for consideration of shareholder-recommended director candidates and the procedures for recommending them. (And if there is no such policy? Then, the proxy statement needs to explain why not.)
- *Source and Evaluation of Director Candidates.* A description of the Nominating & Governance Committee's process for identifying and evaluating potential director nominees will include an explanation of any differences in the process for shareholder-recommended candidates.
- *Board Diversity.* A critical diversity section which discusses whether and, if so, how the Nominating & Governance Committee or Board considers diversity when identifying potential director nominees has had the effect of causing Boards to rethink their diversity policies. The disclosure includes whether the Nominating & Governance Committee or Board has a policy on diversity for director selection and, if so, how it implements the policy and assesses its effectiveness.
- *5% Shareholder-Recommended Director Candidates.* If a 5% or greater shareholder or group that has owned its position for at least a year timely recommends a director candidate, the proxy will, with the individual's consent, disclose the name of the candidate, the shareholder and whether the company nominated the individual.

Communications With the Board. How do shareholders communicate with the Board? A company must describe whether and how shareholders (and for NYSE companies, other interested parties) can send communications to the Board or to specific individual directors and, for NYSE companies, to the nonmanagement directors as a group. (In the unlikely event that there is no method for shareholders to communicate with the Board, the proxy statement needs to explain why not.)

Director Compensation. Finally, a company discloses in a specified tabular format all compensation that it has paid to directors or that they have earned in the most recently completed fiscal year, and provide narrative disclosure of any material factors necessary to understand the information in the table.

Practical Tip: Describing the (Often) Indescribable



Identifying and describing the experience, qualifications, attributes and skills of directors and nominees that make them valuable members of the Board can become logistically and politically challenging without appropriate preparation and coordination:

- As a threshold issue, your proxy drafting team will need to decide who will draft the disclosure: the Nominating & Governance Committee, legal counsel, investor relations or the directors and nominees themselves through a directors' and officers' (D&O) questionnaire.
- You must also decide to whom to circulate the disclosure for review, allowing extra time for the directors and nominees to review their disclosures. Also, who will approve the final disclosure?
- The proxy statement needs to suggest how a director or nominee adds value to the Board as a part of the whole. This necessitates a description of how the director or nominee does or will complement the other Board members.
- The SEC has instructed that disclosure must be provided on an *individual* basis. If all directors or nominees are former CEOs of major companies, for example, the company must describe why that experience makes each individual particularly valuable to the Board at the time the disclosure is made. Companies cannot satisfy this requirement by providing generalized disclosure regarding the entire group.

Audit Committee Report

The Audit Committee publishes its own report in the proxy statement. This report includes disclosure that the Committee reviewed and discussed the audited financial statements with

management, discussed and reviewed with the independent auditors written disclosures regarding the auditors' independence and other matters required by applicable auditing standards. At the heart of this is that the Committee has recommended to the Board the inclusion of the audited financial statements in the company's annual report. A company must also disclose in detail in its proxy statement and Form 10-K the fees paid to the independent auditors and a description of any preapproval policies and procedures.

A company will also disclose in the proxy statement whether representatives of the auditors will attend the shareholders' meeting and whether they will have the opportunity to make a statement or respond to questions.

Filing and Distributing Proxy Materials

E-Proxy Rules: No Cookies!

The SEC's e-proxy rules require each public company to post proxy materials on a publicly available "cookie free" website. The posted materials will include the proxy statement, proxy card, annual report to shareholders, notice of shareholders' meeting, other soliciting materials and any amendments to these materials.

There are two alternatives available to companies to satisfy additional e-proxy requirements related to distribution of proxy materials:

- *Notice-Only Method.* In lieu of mailing full sets of printed materials to shareholders, the *notice-only* option allows companies to post their proxy materials online and mail shareholders a "Notice of Internet Availability" describing the online access. Companies are only required to mail or e-mail full sets of the printed materials upon the request of a shareholder.
- *Full Set Delivery Method.* The *full set delivery* option is the same traditional paper model that companies followed prior to the e-proxy rules. But companies will also need to post their proxy materials online and mail to shareholders the Notice of Internet Availability (which can be combined with the proxy statement).

Companies use a variety of ways to satisfy this mandate, many distributing proxy materials using different methods for different shareholder groups based on criteria such as shareholder zip codes or status as a registered holder (vs. street-name shareholder).

Filing the Notice of Internet Availability

Companies that use the notice-only method of distribution will file a form of the Notice of Internet Availability as additional soliciting materials no later than the date the company first sends the notice to its shareholders.

Filing Preliminary Proxy Statements

Most proxy materials relate only to routine matters such as the election of directors, Say-on-Pay and Say-on Frequency proposals, approval of a compensation plan proposal or ratification of the auditor. A company may file a routine proxy statement with the SEC in final form either prior to or concurrently with distributing the proxy materials to shareholders.

When the proxy materials relate to nonroutine matters (such as authorizing additional shares or otherwise materially amending the charter or approving a merger), a company must file them in preliminary form at least ten days prior to distributing them to shareholders. These preliminary proxy materials are subject to review and comment by the SEC. The SEC will promptly (usually within ten calendar days) advise a company if it intends to review the preliminary proxy materials. If the SEC advises that it will not review the materials, the company may distribute the definitive proxy materials to its shareholders and concurrently file them with the SEC. If the SEC comments on the preliminary proxy materials, the company needs to file amended proxy materials for review.

Distributing the Proxy Statement to Shareholders

State corporate law and a company's governing documents establish the time period for delivery of notice of an annual or special shareholders' meeting. The notice period is generally no less than 10 days (20 days for business combinations) and no more than 60 days prior to the shareholders' meeting date. The notice is usually included as part of a company's proxy statement.

In practice, well-organized companies distribute proxy materials as far in advance of the shareholders' meeting as permitted by applicable notice requirements. Early distribution allows sufficient time for proxy materials to reach beneficial owners, helps ensure the presence of a quorum at the meeting and gives the company time to follow up with shareholders regarding voting.

With the implementation of the e-proxy rules, a company is required to post its proxy materials on the e-proxy website no later than when the Notice of Internet Availability is first sent to shareholders. As a result, any website hosting company or other service provider involved in implementing the e-proxy website will need to receive finalized proxy materials in sufficient time to have the e-proxy website operational prior to that date.

In addition, if companies utilize the notice-only method of distribution, the Notice of Internet Availability must be sent to shareholders at least 40 days before the annual meeting. This means that companies must actually finalize proxy materials prior to the 40-day deadline. With the full set delivery method, this 40-day deadline does not apply.



**Practical Tip:
Save Time for the Brokers!**

The SEC requires intermediaries (i.e., broker-dealers and banks) to comply with the same 40-day deadline for sending the Notice of Internet Availability. You will need to provide any intermediary with the information required in the Notice of Internet Availability in sufficient time for the intermediary to prepare, print and send its own Notice of Internet Availability to the company's beneficial owners by the 40-day deadline. Usually the intermediary will ask to have the information at least 47 days before the annual meeting. Reach out to intermediaries and other service providers directly, well in advance, as many have specific internal deadlines.

The Proxy Card

A shareholder can appoint a proxy by completing the proxy card that accompanies the proxy statement. Rule 14a-4 under the 1934 Act sets forth the specific form and content requirements for the proxy card.

If a company uses the notice-only method, it will need to hold off on mailing the proxy card until at least ten calendar days after mailing the Notice of Internet Availability to shareholders. This gives the shareholder time to access and review the proxy statement. Alternatively, rather than waiting this ten days, the company could mail the proxy card if accompanied or preceded by a copy of the proxy statement and annual report.

**Trap for the Unwary:
Remember Your Optionees and 401(k) Plan
Participants**



Option Holders and 401(k) Plan Participants. Although the primary purpose of a proxy statement is to solicit votes from shareholders, you will also need to get your proxy statement and annual report, as well as other communications distributed to shareholders generally, to holders of stock options and some participants of 401(k) plans with employer stock funds. Hidden in 1933 Act Rule 428(b) is an easy-to-overlook requirement identifying the information to deliver to optionees and other employee benefit plan participants.

Electronic Disclosure. If you adopt the notice-only option or use a stratified approach, pay special attention to ERISA plans with individual accounts invested in your company's stock, such as 401(k) plans and employee stock ownership plans. Delivery of proxy materials electronically may be available only for participants who have properly consented to electronic delivery, or who can access documents furnished in electronic form at any location where the participant works – and then only if access to your company intranet is an integral part of employment duties. We suggest approaching proxy delivery involving these participants with extra care to address compliance with both SEC and ERISA rules, especially in light of recently proposed regulations and evolving disclosure standards under ERISA.

Filing Fees

Generally, there is no SEC fee for filing routine proxy materials. Nonroutine proxy statements that relate to an acquisition, merger,

consolidation, proposed sale or other disposition of substantially all of the assets of a company require payment of an SEC filing fee, which is generally equal to 1/50th of 1% of the value of the transaction.

Shareholder Proposals Submitted for Inclusion in Proxy Materials

Under certain conditions described in Rule 14a-8 under the 1934 Act, a public company must include in its proxy materials a *qualifying* proposal from a shareholder at no expense to that shareholder. These rules provide a means for shareholders to seek shareholder consideration of actions not otherwise proposed by the Board. If the proposal does not meet the procedural and substantive requirements outlined in Rule 14a-8, the company may exclude the proposal from its proxy materials. If the Board does not favor a qualifying proposal, the company may include a statement in opposition to the proposal.

Procedural Requirements

A shareholder must satisfy four procedural steps to be eligible to include a proposal in a company's proxy materials:

- *Stock Ownership.* For at least one year prior to submitting the proposal, the shareholder must have continuously held at least \$2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal. The shareholder must continue to hold the securities through the date of the annual meeting.
- *One-Proposal Limit.* Each shareholder is limited to one proposal for a specific annual meeting. The SEC interprets this to prohibit the submission of a proposal with numerous unrelated subproposals.
- *500-Word Limit.* The shareholder's proposal and accompanying supporting statement cannot exceed 500 words.
- *Notice.* The shareholder's proposal must be delivered to the company's principal executive offices not later than 120 days prior to the anniversary of the date on which the company first distributed its proxy statement for the prior year's annual meeting. Companies generally publish this deadline in the prior year's proxy statement.

If a shareholder fails to satisfy any of these requirements, the company may exclude the proposal on procedural grounds – but only if it notifies the shareholder of any defects within 14 calendar days of receiving the proposal and permits the shareholder an opportunity to cure the defects. The company need not provide a shareholder notice of a defect if the defect cannot be remedied, such as if the shareholder failed to submit a proposal by the company’s properly determined deadline.

What if the shareholder is a no-show at the annual meeting? If the shareholder, or a representative of the shareholder, does not personally appear at the meeting to present the proposal, the company may exclude any proposals submitted by that shareholder from its proxy materials for the following two years unless the shareholder can demonstrate good cause for failing to attend.

Substantive Requirements

Rule 14a-8 also includes several substantive bases on which a company may seek to exclude a shareholder proposal:

- *Improper Under State Law.* The proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company’s organization.
- *Violation of Law.* The proposal would, if implemented, cause the company to violate any state, federal or foreign law to which it is subject.
- *Violation of the Proxy Rules, Including False or Misleading Statements.* The proposal or supporting statement is contrary to any of the SEC’s proxy rules, including Rule 14a-9 under the 1934 Act, which prohibits materially false or misleading statements in proxy soliciting materials. Since 2005, the SEC has denied almost all no-action requests for exclusion or modification of false and misleading statements in shareholder proposals. The effect of this has been that companies that are unsuccessful in negotiating with proponents to exclude offending language will address it either with a disclaimer or in the company’s opposition statement included in the proxy statement.
- *Personal Grievance; Special Interest.* The proposal relates to the redress of a personal claim or grievance against the company or any other person, or is designed to result in a

benefit to the proponent shareholder not shared by the other shareholders at large.

- *Ordinary Business.* The proposal relates to operations that account for less than 5% of the company's total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business.
- *Absence of Power or Authority.* The company would lack the power or authority to implement the proposal.
- *Management Functions.* The proposal deals with a matter relating to the company's ordinary business operations (excluding matters of significant social policy, e.g., senior executive compensation).
- *Election of Directors.* Proposals affecting the election of a member to the Board at the annual meeting. But rules easing the way for shareholders to use the company's proxy statement – known as *proxy access* – may change this. See the next "Breaking News" box below.

Breaking News:

SEC Amends Rules to Permit "Proxy Access" Shareholder Proposals



Effective in late 2011, the SEC amended the shareholder proposal rules to substantially narrow the "election of directors" basis for excluding a shareholder proposal. Companies may no longer exclude proposals seeking to establish a procedure in the company's governing documents for the inclusion of shareholder nominees for director in the company's proxy materials. Companies will still be permitted to exclude certain shareholder proposals relating to the election of directors to the extent they would affect the outcome of the upcoming election.

The effect of this amendment will be to open the door to proxy access by *private ordering*, that is, internal agreement, between shareholders and companies on a company-by-company basis to the extent permissible under state law. An SEC rule imposing "universal" or mandatory proxy access was

Breaking News:
SEC Amends Rules to Permit “Proxy Access”
Shareholder Proposals (Cont’d)



vacated by the U.S. Court of Appeals for the D.C. Circuit in 2011. The SEC has indicated that it remains committed to finding a way to make it easier for shareholders to nominate directors.

In 2009, several new sections were added to the Delaware General Corporation Law to permit Delaware corporations to grant shareholders access to the company’s proxy statement for the nomination of directors and reimbursement of expenses incurred by shareholders in a proxy contest. Companies are not required to implement such provisions, but, if adopted, companies may set forth minimum requirements or limitations, such as requiring a minimum level of record or beneficial stock ownership by the nominating shareholder or conditioning eligibility on the proportion of directors nominated by the shareholder. The American Bar Association has also revised the Model Business Corporation Act to provide for state-level proxy access.

Other Rule 14a-8 bases for exclusion are:

- *Conflicts With Company’s Proposal.* The proposal directly conflicts with one of the company’s own proposals to be submitted to shareholders at the same meeting.
- *Substantial Implementation.* The company has already substantially implemented the proposal.
- *Duplication.* The proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company’s proxy materials for the same shareholders’ meeting.
- *Resubmissions.* The proposal was previously rejected by a specific percentage of shareholders. The percentage is determined by the number of times the proposal has been submitted.
- *Dividends.* The proposal relates to specific amounts of cash or stock dividends.



Practical Tip:
**Now's the Time to Review Your Advance Notice
Bylaw and Procedures for Shareholder
Nomination of Directors**

Advance notice provisions require timely notice to your company by any shareholder proposing director nominations or other business for consideration at a shareholders' meeting. These provisions can give shareholders the chance to evaluate the proposal and the Board adequate time to make an informed recommendation. Here's a checklist to use to review your advance notice bylaws.

- **Are your notice requirements clearly stated?**
Imprecise language in advance notice provisions may permit shareholders to avoid the notice requirements. Your advance notice bylaw should state clearly that:
 - For any nominations or proposals of other business to be properly brought before an annual meeting, a timely notice of shareholder nominations and proposals must be provided to the company in writing in accordance with the bylaws, and the business must be a proper matter for shareholder action.
 - The process for director nominations is separate from the process for other business to be brought by shareholders.
 - The advance notice process will be separate from the requirements of Rule 14a-8 for companies to include shareholder proposals in the proxy statement.
- **Does your bylaw require adequate disclosure about the shareholder proponent?** To enable your Board to adequately assess a shareholder proposal have your advance notice bylaw require:
 - Disclosure of all ownership interests of the shareholder proponent, including derivatives, hedged positions and other instruments that decouple economic risk and voting power;

Practical Tip:
**Now is the Time to Review Your Advance Notice
Bylaw and Procedures for Shareholder
Nomination of Directors (Cont'd)**



- Disclosure of any interest the shareholder proponent may have in the business (other than the election of a director) proposed to be conducted at the annual meeting; and
- Updating of such information, at the company's request, no later than ten days after the record date for the annual meeting.
- **Does your bylaw require adequate disclosure about the proposed nominee?** To enable your Board to determine if a director nominee is qualified, consider having your advance notice bylaw require:
 - Disclosure of the information about the director nominee that would be required in a proxy statement for a contested election;
 - Disclosure of any material relationships, including financial transactions and compensation, between the shareholder proponent and the nominee;
 - Completion of a questionnaire in a form provided by the company that will enable the company to assess the nominee's qualifications, including the nominee's independence; and
 - Updating of such information, at the company's request, no later than ten days after the record date for the annual meeting.
- **Does your bylaw apply to special meetings?** Your advance notice bylaw should include equivalent advance notice procedures for any special meeting of shareholders at which directors are to be elected or shareholders will have the right to propose other business.



Practical Tip:
**Now is the Time to Review Your Advance Notice
Bylaw and Procedures for Shareholder
Nomination of Directors (Cont'd)**

- **Are your time deadlines adequate?** To provide adequate time for your Board to assess a shareholder's proposal, and to facilitate compliance with the requirements of e-proxy, consider extending your notice period. For example, have the notice be delivered no later than the 90th day and no earlier than the 120th day prior to the first anniversary of the preceding year's annual meeting.

Review of Procedures for Shareholder Nomination of Directors. Your company must describe in your annual proxy statement any required procedures to be followed by shareholders in submitting the names of director candidates for consideration by the Nominating & Governance Committee of the Board. Take time to review these procedures for consistency with the requirements of the advance notice bylaw. Does your proxy statement disclosure distinguish between this procedure, which permits shareholders to recommend candidates, and the advance notice bylaw, under which shareholders can nominate candidates directly?

No-Action Letter Requests

If a company intends to exclude a shareholder proposal from its proxy materials on procedural or substantive grounds, it must submit its reasons for doing so to the SEC, with a copy sent simultaneously to the shareholder proponent. This submission is referred to as a *no-action letter request* and must be submitted to the SEC no later than 80 calendar days prior to filing the company's definitive proxy statement. Whether the company is ultimately able to exclude the proposal from its proxy statement will depend on the SEC's response to the no-action letter request. The SEC now accepts no-action letter requests and correspondence related to Rule 14a-8 shareholder proposals via e-mail at: shareholderproposals@sec.gov.

Statement in Opposition to Qualifying Proposal

If a company intends to make a statement in the proxy statement in opposition to a shareholder proposal, the company must provide a copy of the statement to the proponent at least 30 days before filing the definitive proxy statement. If the SEC's no-action letter request response requires the proponent to revise a proposal, the company must provide a copy of the statement in opposition no later than five calendar days after the company receives a copy of the revised proposal.

Identification of Proponent

The proxy statement must include either the proponent shareholder's name, address and share ownership or indicate that the company will provide this information upon request. Although in the past most companies did not identify shareholder proponents, many companies are now including this identifying information in their proxy statements.

Practical Tip: Create a "Countdown" Calendar!



The shareholder proposal process is deadline-sensitive. Begin communicating with a proponent as soon as you receive a shareholder proposal. Create a "countdown" calendar using these key deadlines:

- *Shareholder Proposal Submission Deadline.* 120 calendar days prior to the one-year anniversary of the date on which you sent your prior year's proxy statement to shareholders.
- *Procedural Defects Notice.* 14 calendar days after receiving the shareholder proposal.
- *No-Action Letter Requests.* 80 calendar days before you file your definitive proxy statement with the SEC.
- *Statements in Opposition.* 30 calendar days before you file your definitive proxy statement with the SEC, or within five calendar days of receiving a revised shareholder proposal.

Shareholder Proposals Not Submitted for Inclusion in Proxy Materials

Under certain conditions a shareholder may submit a proposal for consideration at an annual meeting even though the proposal does not meet the procedural requirements for inclusion in the company's proxy statement. The requirements for such submissions are described in the company's bylaws or, in the absence of applicable bylaw provisions, in Rule 14a-4(c). Companies should be aware of the deadlines for these types of shareholder proposals, which are usually provided for in the company's advance notice bylaw provisions, and the applicable deadlines should be disclosed in the company's proxy statement. In addition, a company can generally retain discretion to vote proxies it has received on this type of shareholder proposal if it includes in its proxy statement advice on the nature of the proposal and how it intends to exercise its voting discretion.

The Proxy Contest: Election Contests and Takeover Transactions

As with shareholder proposals, there are various ways that management may appropriately anticipate and manage proxy contests with shareholder groups. A proxy contest typically involves a challenge to existing management by a third-party acquirer or shareholder group seeking control of the company. Often, the challenger has obtained a significant ownership position in the company and seeks to either control the company through the election of a majority of the directors or propose a merger or tender offer for shares. (Although a detailed discussion of takeover transactions and defenses is beyond the scope of this Handbook, we summarize structural defenses in Chapter 10.)

D&O Questionnaire

A company's proxy statement, Form 10-K and annual report to shareholders will provide a variety of detailed information about its directors and officers, including employment history, compensation, security ownership in the company, related transactions with the company and Section 16 reporting compliance history. Even if a company believes it already knows all the relevant information, the

company should ask its directors and officers each year to complete a D&O questionnaire to elicit or confirm the required information. Companies will want to review and update as necessary their D&O questionnaires annually to incorporate changes to applicable SEC requirements and NYSE and Nasdaq rules. Companies should provide the D&O questionnaires to directors and officers sufficiently in advance to allow adequate time for responses to be incorporated into the proxy statement, Form 10-K and annual report. A helpful approach is to include a copy of relevant portions of the prior year's proxy statement, Form 10-K or annual report with the D&O questionnaire and request that the directors and officers update and edit the information as needed.

In addition to responding to the requests in the D&O questionnaire, a director or officer may know information about the company or its operations, including its transactions with related parties, that may be disclosable in the proxy statement but may not necessarily involve the director or officer personally. In those cases, the director or officer should confirm with the company's legal counsel whether the information needs to be disclosed in the company's proxy statement or other periodic reports.

The Annual Report to Shareholders

In the annual report to shareholders, senior executives have an opportunity to communicate directly with the company's shareholders. Unlike the corporate governance focus of the annual proxy statement, the annual report conveys information regarding the company's business, management and operational and financial status.

Content Requirements of the Annual Report to Shareholders

The "glossy" annual report to shareholders has similar content requirements to Form 10-K, but serves a different purpose. The Form 10-K fulfills the year-end reporting requirement to the SEC, is not delivered to shareholders (just filed with the SEC) and, as such, is not necessarily designed to communicate with shareholders. The annual report to shareholders, by contrast, is intended principally as a communication device – the most direct message from the company to its shareholders – and is generally issued in an easy-to-read format to facilitate this purpose.

Rules 14a-3 and 14c-3 under the 1934 Act specify the minimum content requirements for an annual report. These include:

- *Financial Information.* Audited balance sheets for the two most recent fiscal years, audited statements of income and cash flows for the three most recent fiscal years, other selected and supplemental financial data, a discussion of material uncertainties and disagreements with accountants on accounting and financial disclosure, MD&A detailing financial condition and results of operations, and disclosures about market risk.
- *Stock and Dividend Information.* Identification of the principal markets in which the company's shares are traded, quarterly highs and lows in stock price, number of common shareholders, and frequency and amount of cash dividends declared over the previous two fiscal years.
- *Stock Performance.* A performance graph comparing the change in total shareholder return on common stock with an equity market index and the cumulative total return of a published industry index or peer issuers (disclosing the basis for its selection) for the last five fiscal years.
- *Operation and Industry Segment Information.* A description of the company's principal products produced or services rendered, accompanying markets and distribution methods, foreign and domestic operations, export sales, industry segments and classes of similar products or services.
- *Director and Officer Information.* Identification of the company's directors and executive officers along with their principal occupations, including the names of their employers.

Companies are free to include information in the annual report that goes beyond the minimum content requirements. Companies generally include a letter from the president or chairman of the Board summarizing the company's operations, strategy, projected performance, key personnel changes and other highlights for the year. Because the annual report is furnished to the SEC and generally made publicly available, any information included in the

annual report, even if not required, may be the source of legal liability if found to be materially misleading.

Format Requirements of the Annual Report to Shareholders

Format requirements for the annual report are minimal. The SEC permits virtually any format but encourages innovative presentation, including the use of tables, graphs, charts, schedules and other graphic illustrations useful to presenting operational and financial information in an easily understandable manner. Some of the financial information included in the body of the annual report must be presented in tabular form.

Practical Tip:
It's a Wrap!
Consider Doing a Form 10-K "Wrap"



Companies are increasingly using a Form 10-K *wrap* annual report to shareholders. This consists of eight or so glossy pages of company message materials (e.g., president's or chairman's letter, photographs of the company, management or products) that simply wrap around the Form 10-K. This avoids duplication between the annual report and the Form 10-K, while reducing costs. A similar cost-saving approach is to send shareholders a combined document, which includes both the proxy statement and the annual report.

Timing of the Annual Report to Shareholders

The SEC requires an annual report to shareholders to accompany or precede a company's proxy statement for any shareholders' meeting (annual or special) at which shareholders will elect directors. While a company need not prefile its annual report to shareholders with the SEC (unlike with the other proxy materials), each company does need to furnish seven copies of the annual report to the SEC when it distributes it to shareholders. NYSE companies must also provide copies to the NYSE.

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Chapter 6

Annual Meeting of Shareholders

For the first several months of each fiscal year, a public company's senior management and professional advisors will spend significant energy preparing for the company's annual meeting of shareholders. Agreeing to a premeeting timetable can bring order to this process and help ensure timely completion, as many of the tasks to include in the timetable will require significant lead time.

Practical Tip:
**Create a Calendar or Time and Responsibility
Schedule and Update It During the
Planning Period**



The Annual 1934 Act Reporting Calendar in Appendix 1 can help you plan your annual meeting process. Your calendar or time and responsibility schedule (T&R) should identify the group or individual in charge of each task, and set a due date for accomplishing the task. One person should take responsibility for updating and recirculating the T&R on a regular basis during the planning period to reflect the current status or completion of the necessary tasks. Be sure not to mark a task as done until it is actually completed.

Tailor your company's calendar to the rules and regulations that govern the proxy materials, the annual report to shareholders and the annual meeting. These rules derive from:

- Federal securities laws regulating proxy solicitations, annual reports and public disclosure generally;
- Exchange rules and regulations;



Practical Tip:
**Create a Calendar or Time and Responsibility
Schedule and Update It During the
Planning Period (Cont'd)**

- The company's governing documents, such as its certificate or articles of incorporation, bylaws, Board guidelines and policies and Committee charters; and
- State corporate law.

The calendar for each company will be different and its preparation will require some judgment. For example, a company's bylaws may require the company to deliver notice to its shareholders of the annual meeting date earlier than the SEC's proxy rules or applicable state corporate law may require, or the company's certificate of incorporation may require a supermajority vote (such as two-thirds) on a particular proposal while applicable state corporate law requires only a simple majority. Each company should work with its counsel to identify and comply with the most restrictive applicable requirements.

Premeeting Planning

Setting the Annual Meeting Date

The determining factors in setting an annual meeting date are:

- State corporate law;
- The prior year's annual meeting date; and
- The company's certificate of incorporation and bylaws.
(These governing documents either set the annual meeting date or give the Board discretion to choose a date.)

State corporate law sets forth a time frame during which companies must hold an annual meeting. For example, if a Delaware company fails to hold an annual meeting within 30 days after the date fixed for the company's annual meeting in its charter documents (or, if that date is not fixed, 13 months after its previous annual meeting),

a shareholder or director can bring an action in the Delaware Court of Chancery to force the company to hold its annual meeting.

Determine the Annual Meeting Location

As early as a year in advance, individuals with responsibility for annual meeting logistics should anticipate the number of shareholders who will attend the annual meeting and reserve an adequate facility. State corporate laws for most jurisdictions permit annual meetings to be held within or outside the state of jurisdiction (including, in the case of some jurisdictions, such as Delaware, in cyberspace), in accordance with the company's certificate of incorporation and bylaws.

Many companies hold their annual meetings at the same location each year, either in their corporate offices or in conference facilities nearby. Holding the annual meeting at a corporate office can result in great price savings, and will allow the company to be on familiar ground with everything from audio/visual equipment to security. An annual meeting at the company's offices provides shareholders the opportunity, during or after the meeting, to see new product demonstrations or to take a facility tour. Some larger companies rotate their annual meeting from year to year among cities where they have facilities.

Virtual Annual Meetings

State corporate laws for many jurisdictions permit companies to supplement their annual meetings with virtual components or virtual shareholder participation at in-person meetings. Some state laws require that a physical meeting accompany a virtual annual meeting. Under the corporate law of Delaware and an increasing number of other jurisdictions, however, a company can hold an entirely virtual annual meeting in lieu of a physical meeting if the company's charter documents so provide. There are, of course, other legal, procedural, technical and administrative issues that need to be thoroughly considered before introducing a virtual component into the annual meeting.

Virtual annual meetings have gained momentum in recent years, despite objections from some shareholder groups. Virtual annual meetings present the following potential benefits:

- Expanding attendance and shareholder participation;

- Saving meeting costs; and
- Creating branding and messaging opportunities to employees, shareholders and others.

Opponents of virtual annual meetings claim that shareholders could lose the valuable ability to confront management in person, that companies could manipulate virtual question-and-answer sessions, and that voting “surprises” could occur. For these reasons and others, relatively few companies have shifted to entirely virtual annual meetings. Some companies opt for a hybrid annual meeting format that includes both a physical meeting and a virtual component. The most common form of hybrid meeting provides a virtual component in the form of real-time audio and/or webcast, but not an ability to vote virtually during the meeting. For more information regarding webcasts, see Chapter 3 and “Practical Tip: Webcast the Annual Meeting” later in this chapter.

Setting the Record Date

Only shareholders of record on the record date for the annual meeting are entitled to notice of, and to cast votes during, the meeting. Shareholders that acquire a company’s stock after the record date have no voting or notice rights with respect to the meeting. A company’s Board sets the record date for the annual meeting. State corporate laws set the maximum and minimum number of days between the record date and the meeting date. In Delaware, for example, the record date may not be more than 60 nor less than 10 days before the meeting. Some companies’ bylaws set further limits on the record date.

Delaware recently amended its state corporate law to permit the use of separate notice and voting record dates. The amendment was designed to address the *empty voting* problem that arises when a shareholder has a voting right in a company but not a corresponding economic interest. Federal securities laws, however, require the timely distribution of proxies to all shareholders and therefore limit the applicability of this provision. The SEC is considering changes to its rules to accommodate dual record dates. If only a single record date is set, that record date establishes both the right to notice and the right to vote.

Trap for the Unwary: What's the Holdup?



Recently, a West Coast-based Delaware public company decided that it would hold its annual shareholders' meeting 15 months after its most recent shareholders' meeting. The company announced that it had retained an investment banker to advise it on its strategic alternatives, including searching for a possible merger partner. In setting the meeting date, the Board intended to allow sufficient time to present any proposal resulting from the investment banker's efforts to the company's shareholders for their approval at the annual meeting.

A group of shareholders threatened to sue to compel the company to hold the annual meeting earlier than the company's announced date and within 13 months after the company's prior year's annual meeting.

The Delaware Court of Chancery's power to force a meeting is discretionary. The court considers a number of factors when deciding whether to compel a meeting to be held at the request of a complaining shareholder or director. If the company has a valid reason for delay (such as taking a merger proposal to its shareholders) and is taking steps to hold the meeting promptly, the court generally refrains from compelling an earlier meeting.

In this case, the company completed the strategic analysis with its financial advisor as promptly as possible and rescheduled its annual meeting to within 14 months after its most recent meeting. By the time the original 13-month period expired, the company had mailed its notice and proxy statement, and no shareholder brought suit.

Notifying Shareholders and Exchanges

State corporate law requires a company to notify its shareholders in writing of the annual meeting date, time and place. Notice periods vary from state to state. In Delaware, the notice period is at least 10 days and no more than 60 days prior to the annual meeting. Failure to adhere to notice requirements can have significant consequences. In Delaware, for example, unless notice is waived, a company's failure to adhere to notice requirements voids

any action taken at the annual meeting. Each company should also comply with any notice provisions in its governing documents. In addition, companies taking advantage of the “notice only” option for distributing proxy materials will be subject to additional notice requirements under the e-proxy rules.

The exchange on which a company’s shares are listed may also require notice of an annual meeting. For example, listed companies must provide the NYSE with prompt notice of the fixing of a record date. The notice must be given at least ten days prior to the record date established for the meeting, and must indicate the meeting and record date and describe or attach materials describing the matters to be voted at the meeting. Although the NYSE may not widely publicize this notice, it can publish annual meeting information in its weekly bulletin to listed companies.

Reaching Past “Street Name” to Contact Beneficial Owners

Because many owners of public company stock hold their shares in *street name* (i.e., by having a brokerage firm, bank or other *nominee* hold the shares in its name for the benefit of the actual investor), a public company cannot contact its shareholders directly by simply using its transfer agent’s list of record holders. To facilitate this contact, the SEC, the exchanges and the nominees themselves have developed rules, practices and procedures to make sure the materials will eventually be delivered to the investors (beneficial owners) that have economic ownership of shares held in street name.

Rule 14a-13 under the 1934 Act and exchange requirements require companies to send a sufficient amount of shareholder materials to the nominees for them to distribute to beneficial owners. Under Rule 14a-13(a)(3), companies must contact institutional nominees at least 20 business days before the record date to learn the number of copies of the proxy and other soliciting materials needed for distribution to beneficial owners.

Once a company has its proxy materials ready for distribution, Rules 14b-1 and 14b-2 under the 1934 Act require nominees to furnish proxy materials to beneficial owners who will not receive those materials directly from the company within five business days of the nominee’s receipt of the materials from the company. Many nominees outsource proxy distribution to third-party service providers, such as Broadridge Financial Solutions. We discuss the mechanics of proxy statement delivery, including the need to give the bank or broker intermediaries time to fulfill their proxy statement delivery requirements, more fully in Chapter 5.

Shareholders that intend to solicit proxies in opposition to a proposed action to be taken at an annual meeting have the right to access information regarding beneficial ownership. Delaware courts have ruled that soliciting shareholders are entitled, in addition to a list of record holders, to other information readily obtainable by the company that identifies beneficial owners, provided they take the necessary steps in time to obtain the information.

Practical Tip:
Electronic Shareholder Forums:
Watch Your E-Tongue!



Since 2008, the SEC's proxy rules have encouraged the use of electronic shareholder forums to facilitate communication among shareholders and between shareholders and companies. If you participate, directly or on behalf of your company, in an online forum, take care to ensure that your communications contain no material misstatements or omissions and refrain from engaging in selective disclosure. Just like a communication on a company website, blog or social networking site, your statement in an electronic forum needs to comply with exchange rules regarding public disclosure, Rule 10b-5 under the 1934 Act and Regulations G and FD.

A technical note: If you participate in an online shareholder forum, the general rule is that your communications made more than 60 days before the meeting date will be exempt from the proxy rules – so long as you are not seeking the power to act as a proxy.

Who Attends the Annual Meeting?

Shareholders. Many public companies have a large and geographically dispersed group of shareholders. For this reason, and because many shareholders vote by proxy rather than at the annual meeting, frequently only shareholders who live in the vicinity of the meeting and employee shareholders attend.

Management and Board Members. Senior management and some or all members of the Board typically attend the annual meeting. Their attendance provides shareholders an opportunity to meet and provide feedback to the Board and management team. A

company is required to describe in its proxy statement any policy regarding director attendance at the annual meeting, and how many directors attended the prior year's meeting.



Practical Tip: **Webcast the Annual Meeting**

If your company wishes to present a general business update that may include material nonpublic information at its annual meeting, you should make arrangements to webcast the meeting to ensure compliance with Regulation FD. To webcast your annual meeting:

- Include in the press release announcing the meeting a notice that the company will discuss general business updates;
- Arrange for, and pretest, webcast media facilities at the meeting's site;
- On the day of, but prior to, the meeting, issue a press release with the text of the company's planned presentation, or at least the material nonpublic portions;
- Comply with Regulation G by posting any required GAAP information and reconciliations on the company's website and providing the website address during the presentation;
- Begin the business update with cautionary language on forward-looking disclosures;
- Post any questions and responses in the same manner as after an earnings release; and
- If the presentation includes the first public communication of previously material nonpublic information discussing a historic, completed quarter or year (whether or not it includes non-GAAP financial information), "furnish" this nonpublic earnings information on Form 8-K under Item 2.02.

See Chapter 3 for a full discussion of webcasts and shareholder or analyst calls and furnishing nonpublic earnings information.

Inspector of Elections. The company should arrange for an inspector of elections to tabulate votes and certify results. Sometimes the inspector is a company employee. More often, the inspector is a representative of the company's transfer agent or independent auditors. Ideally, the inspector is truly independent and unrelated to the company or its regular service providers. The company should be familiar with the inspector's qualifications and be prepared to answer shareholder questions regarding the inspector. In cases of close voting, a well-prepared, well-qualified and independent inspector will provide support for a company if a shareholder later challenges the voting results.

**Trap for the Unwary:
Remember to "8-K" Your Voting Results**



Form 8-K requires you to disclose shareholder voting results under Item 5.07 of Form 8-K within four business days of the date of the annual shareholders' meeting. If your final voting results are not available to meet that deadline, you must file a Form 8-K with preliminary voting results, and amend it within four business days of the date on which you know the final voting results. In addition, remember to file an amendment to Item 5.07 of Form 8-K to disclose your Board's Say-on-Frequency vote decision. This amendment must be filed no later than 150 calendar days after the date of the annual meeting, and in no event later than 60 calendar days prior to the deadline for the submission of a Rule 14a-8 shareholder proposal for the next annual meeting.

Counsel and Auditors. Representatives from the company's legal counsel and independent auditors usually attend the annual meeting. The independent auditors can field questions regarding the company's financial statements. Legal counsel attend to address any voting, agenda or procedural issues that may arise.

Board Meeting or Board Consent to Address Matters Pertaining to the Annual Meeting

Three to four months prior to the annual meeting, a company's Board should:

- Fix the meeting's time, date and place;

- Set the record date(s);
- Determine the mailing date;
- Approve the engagement of a proxy solicitation firm if one will be used;
- Establish the purposes of the meeting (generally, to elect directors, vote on specified matters and transact other business as may properly come before the meeting);
- Select director nominees;
- Appoint the inspector of elections; and
- Designate proxies.

At the same time, the Audit Committee should indicate what firm it has selected as the company's auditors if it has not done so already. The Audit Committee may also recommend that its appointment of the auditors be submitted to the shareholders for ratification.



Practical Tip:
**Hold a Board Meeting in Connection
With the Annual Meeting**

Most companies hold a meeting of the Board either just prior to the annual meeting, to discuss matters that may be presented at the annual meeting, or just after the annual meeting, when the officers will not be distracted by preparation for the annual meeting. Holding a Board meeting on the annual meeting date helps ensure Board member attendance at the annual meeting.

Script, Agenda and Rules of Conduct

Most companies prepare a script, agenda and rules of conduct for the annual meeting. It is good practice to distribute the agenda and rules of conduct to attending shareholders as they arrive.

Script and Agenda. The script will cover all items on the agenda and all statements that the scheduled speakers will make during the annual meeting, as well as draft answers to any questions that management can anticipate. An agenda typically includes the following:

- Chairperson's opening remarks and call to order;

- Introduction of management, directors and advisors in attendance;
- Establishment of proper meeting notice and quorum;
- Introduction of items to be voted on;
- Voting instructions;
- Opening and closing of polls;
- Report of the inspector of elections and the announcement of voting results;
- Closing remarks and adjournment of formal portion of meeting;
- Management presentations regarding the company's business; and
- Question-and-answer period.

Follow the Script! Regulation FD. The script plays a critical part in complying with Regulation FD by anticipating questions that may call for an answer that would reveal material nonpublic information. The company's investor relations officer should carefully review these areas and either:

- Propose issuing a press release, or using any other dissemination method that is compliant with Regulation FD, prior to the annual meeting to disclose material nonpublic information that can reasonably be expected to be discussed; or
- Flag the topics for the CEO and CFO, and draft a response that does not disclose material nonpublic information.

Speakers will want to rehearse the script before the annual meeting and should pay particular attention to warnings on disclosure of material nonpublic information.

Rules of Conduct. Rules of conduct typically limit shareholders' time to address the annual meeting, describe how the company will handle unscheduled proposals and address how to handle unruly shareholders.



Practical Tip: Calming the Contentious Shareholder

While shareholders have an opportunity to be heard at an annual meeting, a company should take measures to prevent a shareholder from monopolizing other shareholders' time and impeding the meeting's progress. Management can best prepare to calm a contentious shareholder with clear rules of conduct and thorough planning. Rules of conduct should address the types of activities that may cause the company to remove a shareholder. The chairperson of the annual meeting should warn a disorderly shareholder whose actions are out of order. If preliminary steps do not restore order, the chairperson should follow planned steps to remove the shareholder and, if necessary, adjourn the annual meeting or call for a recess.

Materials to Bring to the Annual Meeting

Most companies have an admissions desk staffed with friendly company representatives and materials for the annual meeting attendees. Each attendee will receive the meeting agenda and rules of conduct. The company should also have available extra copies of its proxy materials, annual report and Form 10-K for distribution at the request of any attendee. Additionally, the corporate laws of most states require that companies make available to their shareholders a list of shareholders entitled to vote at the annual meeting and that such list be available at the meeting.

Voting and Quorum Requirements

Voting in Person or by Proxy

A shareholder with voting power may vote at the annual meeting by attending in person and casting a ballot or by designating a proxy to act on the shareholder's behalf. In general, a proxy holder has broad discretion to vote the shares covered by the proxy. Under Delaware corporate law, for example, a proxy generally allows the proxy holder to vote shares in the proxy holder's discretion on any

issue that is properly raised at an annual meeting, unless the proxy specifically limits the holder's authority.

Quorum

Before shareholders can conduct business at an annual meeting, a quorum must be present. Quorum requirements generally are governed by state corporate law and the company's certificate of incorporation and bylaws. Usually, a quorum consists of a majority of the shares entitled to vote at a meeting. Shares count for quorum purposes if present at the meeting either in person or by proxy.

Broker Nonvotes

When beneficial owners fail to instruct the company or the beneficial owner's nominee how to vote on certain matters deemed to be "routine," the nominee may vote the shares for or against the proposal in its discretion. Matters on which a nominee may vote a beneficial owner's shares in its discretion are known as discretionary matters. Each nominee ultimately sends a proxy to the company containing the cumulative result of beneficial owners' instructions and the nominee's votes on those discretionary matters for which it did not receive instructions.

National stock exchanges prohibit brokers and other nominees from voting shares they do not beneficially own with respect to the election of directors, executive compensation proposals and certain other nondiscretionary matters unless they receive specific voting instructions from the beneficial owners. Instead, a beneficial owner must give specific instructions to the nominee to vote on the nondiscretionary matter or else the shares cannot be voted and a broker nonvote occurs. Broker nonvotes are votes that a broker cannot cast with respect to the particular nondiscretionary matter.

Breaking News: Uncontested Director Elections and Executive Compensation Proposals No Longer Discretionary



In the wake of the Dodd-Frank Act, the NYSE and Nasdaq no longer allow brokers and other intermediaries to vote uninstructed shares on the election of directors, executive compensation matters or other significant matters as determined by the SEC. These revised rules may make it more difficult to achieve a quorum and for management nominees to achieve a majority vote. Companies will want to consider including at least one annual meeting agenda item that qualifies as “routine” – such as the ratification of the company’s auditors – to help with a quorum count.

Abstentions

A person with voting power (whether as a beneficial owner of shares, a designated proxy holder or a broker with discretionary authority to vote shares) who is present in person or by proxy at an annual meeting has the discretion to abstain from voting.

The Effect of Abstentions and Broker Nonvotes

Each company’s proxy statement relating to an annual meeting must describe how abstentions and broker nonvotes count toward the tabulation of each proposal presented at the meeting.

Quorum. Delaware and Model Business Corporation Act (MBCA) states count both abstentions and broker nonvotes as “present” for the purpose of establishing a quorum.

Voting. The effect of abstentions and broker nonvotes on the outcome of a shareholder vote will vary based on:

- The state’s corporate law treatment of abstentions and broker nonvotes; and
- The vote required to approve the shareholder action, which may be governed by state corporate law, a company’s certificate of incorporation or bylaws, or exchange rules.

Vote Required: Fixed Percentage of Shares Present and Entitled to Vote. Under Delaware corporate law, unless otherwise provided in the company's charter documents, most routine shareholder actions, other than the election of directors, require the affirmative vote of a fixed percentage of the voting shares that are present, either in person or represented by proxy, and entitled to vote on the matter presented at the meeting. Because abstentions are present and entitled to vote on the matter presented at the meeting, they have the effect of counting as votes against the proposal – they add to the pool of votable shares without contributing to the affirmative votes required to approve the shareholder action. Broker nonvotes, however, while present for purposes of a quorum, are not entitled to vote on the matter presented at the meeting. Broker nonvotes, therefore, are excluded from the pool of votable shares and have no effect on the outcome of the shareholder vote.

It is important to refer to the corporate law of a company's state of incorporation for its treatment of abstentions and broker nonvotes. For example, under New York corporate law, abstentions are treated differently than they are treated under Delaware law. In New York, unless the company's shareholders have adopted a bylaw or provided otherwise in the certificate of incorporation, abstentions have no effect on the approval of a proposal other than the election of directors.

Vote Required: Fixed Percentage of Outstanding Shares. Approval of some shareholder actions requires the affirmative vote of a fixed percentage of the company's outstanding voting shares, whether or not such shares are present at the meeting. Under Delaware corporate law, mergers, sales of substantially all the company's assets, amendments to the company's certificate of incorporation and dissolutions all require the affirmative vote of a majority of the outstanding voting shares. For these proposals, abstentions and broker nonvotes are the same as votes against the proposal because both are included in the pool of the company's overall voting shares, although they do not count toward the affirmative vote needed to approve the shareholder action.

Default Vote Required for Election of Directors: Plurality of Votes Cast at a Meeting. The corporate laws of both Delaware and MBCA states require only the affirmative vote of a plurality of votes actually cast at the meeting to elect directors and, in MBCA

states, to approve most other shareholder matters, unless a company's charter documents provide otherwise. This means that more votes must be cast in favor of the action than votes cast for any other alternative, whether or not the approving votes constitute a majority or other fixed percentage. Abstentions and broker non-votes do not affect the vote's outcome because they are neither votes cast for nor votes cast against the action.

Majority Voting in Election of Directors. Many larger public companies have moved away from plurality voting and adopted a form of majority voting standard for the election of directors. The majority voting standard for director elections requires that, in order to be elected, a nominee must receive more votes "for" than "against," which may include any votes withheld, depending on the definition of *majority* to be elected. One approach for implementing a majority voting standard is through an amendment to a company's bylaws. As a result, there have been changes to the Delaware corporate law and the MBCA to accommodate majority voting bylaw amendments and related matters. For example, Delaware bylaws may even prohibit directors from unilaterally amending shareholder-approved bylaw provisions implementing majority voting. Delaware law also includes a provision that permits irrevocable director resignations that are effective upon the occurrence of a future event, which could include a director's failure to be elected by a majority vote.

Shareholder Actions by Written Consent in Lieu of an Annual Meeting

In some states, shareholders may act by written consent in lieu of an annual meeting. Although technically permitted, action by written consent in lieu of an annual meeting has little practical value for the public company. Under Delaware corporate law, for example, shareholders may act by written consent to elect directors in lieu of an annual meeting, but only if the consent is unanimous or, if not unanimous, if all directorships to which directors could be elected at an annual meeting held at the written consent's effective time are vacant (by way of resignation or removal) and filled by such written consent. In addition, Section 14(a) of the 1934 Act extends the proxy rules to solicitations of written consents, and exchange rules may also apply.

Chapter 7

Corporate Governance: Best Practices in the Boardroom

The Board of Directors bears ultimate responsibility for the oversight of a company's business and affairs. The Board makes fundamental decisions about strategic focus, establishes significant policies and approves the hiring, firing and compensation of executive officers who manage day-to-day business operations. Directors monitor financial reporting and public disclosure, and oversee risk management, including oversight of internal controls and compliance with laws. The Board also sets the tone for ethical business conduct. This chapter describes how members of a Board, and its Audit, Compensation and Nominating & Governance Committees, can best fulfill these duties.

Although our discussion uses concepts from Delaware law, similar principles apply in other states.

Practical Tip: **Best Practices and Better Still. The Evolving Standards of Corporate Governance**



Directors face a sometimes bewildering array of corporate governance requirements. Where do they come from?

- *State Law.* The corporate statutes and court decisions of a company's state of incorporation provide the basic "rule book" for a Board. State corporate law controls all aspects of corporate life, from the very simple – shareholder notice and voting requirements – to the complex – fiduciary duties and liability.



Practical Tip:
Best Practices and Better Still. The Evolving Standards of Corporate Governance (Cont'd)

- *Federal Law.* Federal law, primarily through Congress and the SEC, regulates the governance of public companies, mandating, for example, entirely independent Audit and Compensation Committees and codes of ethics for CEOs and senior financial officers.
- *NYSE and Nasdaq.* The NYSE, Nasdaq and other exchanges impose governance standards on their listed companies, requiring, subject to limited exceptions we discuss in Chapters 8 and 9, independent Audit, Compensation and Nominating & Governance Committees, a majority of independent directors and executive sessions of nonmanagement directors. All public companies will have an Audit Committee and all listed companies will have a Compensation Committee, both made up of independent directors. The NYSE requires, and Nasdaq suggests, an independent director Compensation Committee. The NYSE requires a Nominating & Governance Committee, while Nasdaq requires either a Nominating & Governance Committee or that independent directors meet in executive session to deal with director nominations. (Chapters 8 and 9 discuss the NYSE's and Nasdaq's committee requirements in detail.)
- *Institutional Investors.* Institutional investors have applied increasing pressure on public companies to adopt corporate governance practices that the investors believe are in the best interests of shareholders. Those practices include eliminating staggered Boards, giving shareholders the right to call special meetings, having shareholders approve poison pills, independent chairs, and the adoption of "majority vote" procedures for annual shareholders' meetings.

Practical Tip:
**Best Practices and Better Still. The Evolving
Standards of Corporate Governance (Cont'd)**



In short, many of yesterday's "best practices" have become today's baseline requirements. New best practices continue to evolve as companies, regulators, institutional investors and corporate governance commentators debate the many new governance rules and standards that apply to public companies.

This chapter reviews best practices of corporate governance at the time this Handbook went to press in 2011. And, in Chapters 8 and 9, we describe in detail the governance standards of the NYSE and Nasdaq. We also make suggestions that may help your Board to stay abreast of best practices of corporate governance that are sure to evolve in the years to come.

Director Responsibilities

State statutes, court decisions and, increasingly, federal laws and regulations define the duties of directors. Yet even after the implementation of many new regulations, the basic duties of directors remain unchanged. Although there are nuances in the duties imposed by various states, most generally hold directors to fiduciary duties of care and loyalty. In recent years, some courts have imposed the additional duty of candor.

Duty of Care

Directors owe the company and its shareholders a duty to exercise the care that an ordinarily prudent person in a comparable position would exercise under similar circumstances. A director is not presumed to have special management skills, but is expected to exercise common sense and apply the skills he or she possesses. The time needed to fulfill the duty of care will increase with the importance and complexity of the proposed corporate action. These significant decisions, for example, require substantial investigation and consideration:

- Merging or selling the company;
- Establishing or waiving antitakeover defenses;

- Hiring, terminating or setting compensation for management;
- Approving debt or equity offerings, or other material financings;
- Entering into new lines of business; and
- Approving an annual budget or business plan.

Due care requires a director to apprise herself of all reasonably available material information prior to making a business decision. A director can best assess each proposal's strengths and weaknesses by taking these steps:

- Ask for sufficient notice of each Board meeting to allow for preparation;
- Require – and review – written background documentation describing the rationale and key terms of any proposed transaction prior to the meeting;
- Discuss the proposed issue with the company's management and legal and financial advisors;
- Attend meetings in person or by telephone in a way that allows you to participate and to learn of all information available to the Board; and
- Make sufficient inquiry – ask questions prior to and at the Board and committee meetings – in order to discuss and understand as fully as possible all the relevant issues, including the risks of executing the business decision.

**Practical Tip:
No Speeding!**



You may want to use this image to illustrate the duty of care for your Board:

“Directors get in trouble for speeding, not for running the car off the road!”

In other words, the Board should act in good faith to make its best thoughtful, considered and informed decision. If no conflicts of interest exist and the Board follows an appropriate process, courts usually will not second-guess the directors even when, in hindsight, the Board makes a wrong choice, takes a wrong turn, or causes a loss to the company.

In making decisions, a director may generally rely on information and reports from the company’s officers and employees, legal, financial and other advisors, and Board committees. Reliance, however, must be “eyes open” and prudent. Each director should assess the qualifications of the parties providing information and advice and examine the work product. A director may not rely on information or advice if the director has knowledge that would make reliance unreasonable. In reviewing material, the three best rules of thumb are simply:

- Ask;
- Ask; and
- Ask.

Duty of Loyalty

A director owes the company and its shareholders a duty of loyalty to give higher priority to corporate interests than to his or

her personal interests in making business decisions. If a director has a personal interest in a matter, he or she must fully disclose the interest to the Board and will often abstain from voting on or participating in discussion of the matter. Similarly, directors should not pursue, other than through the company, business opportunities that relate to the company's existing or contemplated business unless disinterested members of the Board, after full disclosure, have decided that the company will pass on the opportunity.

Conflicts of Interest. Conflicts of interest and corporate opportunities arise regularly in the day-to-day conduct of a Board's business. A director may, for example, have a corporate opportunity or conflict of interest as a result of:

- An inside director's employment or severance arrangement;
- An issue that is material to the director's employer; or
- An interest in the potential purchaser in a change-of-control transaction.

The frequency of conflicts of interest has given rise to a host of mechanisms to manage conflicts. Using them should permit a Board to act responsibly. Ways to manage conflicts of interest include:

- *A Majority of Disinterested Directors Approve, and Interested Directors Abstain.* If only one director, or a small number of directors on a larger Board, has a conflict of interest, a majority of the disinterested directors may approve the transaction. In this situation, a director with a conflict should fully disclose her conflict, including all facts that would be relevant to the Board's decision, remove herself from discussion at appropriate times, and abstain from voting.
- *A Wholly Independent Committee Approves.* The Board may establish an independent committee of disinterested, independent directors to approve a particular transaction. Either the Board chair or disinterested directors will take the lead in establishing the committee. The Board may either delegate the final decision to the committee or ask the committee to make a formal recommendation to the

Board for approval. The committee should act independently, with an adequate budget to seek independent legal counsel and other advisors, as the committee feels appropriate.

- *Approval by Shareholders.* If all or nearly all directors have a conflict of interest, the Board may ask for shareholder approval of a particular transaction. The proxy statement disclosure to shareholders should describe the transaction and fully disclose all conflicts of interest and other relevant information. The Board may either recommend the transaction to the shareholders or call for a shareholder vote without a Board recommendation.

In unusual situations, where all or virtually all directors have a conflict, and where shareholder approval is impractical or the shareholders themselves have conflicts of interest, the Board may take an action that it believes to be “entirely fair” to the company. It is rare for a public company to act on this basis. Shareholders have the right to challenge a transaction in which the directors have a conflict and the transaction is nonetheless approved by the Board. A court will uphold the action if it establishes that the action was fair to the company at the time the Board approved it.

Duties to Other Stakeholders

The interests of the company and its shareholders, while primary, are not the sole consideration of the Board. Some states have adopted *constituency statutes* that now permit directors to consider the interests of other constituents, including employees, customers, suppliers and communities when making business decisions. In addition, when a company becomes or is likely to become insolvent, the director’s duty of loyalty may shift to include the company’s creditors.

Duty of Candor

Delaware judicial decisions have articulated a duty of candor or disclosure. This additional responsibility derives from both the duty of care and the duty of loyalty. The duty of candor calls on directors to disclose to their fellow directors and the company’s shareholders all material relevant information known to them that

is relevant to the decision under consideration. In judging whether a director has satisfied his or her duty of candor, courts will examine the materiality of all undisclosed or underdisclosed information.

Judicial Review: Business Judgment Rule

Courts apply the business judgment rule in reviewing most decisions made by directors. Under the business judgment rule, courts defer to the decisions of disinterested directors absent evidence that the directors did not act in good faith or were not reasonably informed about the decision, or that there is no rational business purpose for the decision that promotes the interests of the company or its shareholders.

Enhanced Scrutiny: The Unocal and Revlon Standards

Courts in Delaware and other states apply a more stringent *enhanced scrutiny* standard when examining transactions involving the adoption of antitakeover measures, implementation of deal-protection mechanisms such as lock-up options, a change of control or a breakup of the company.

When applied in measuring the appropriateness of antitakeover or deal-protection measures, this standard is known as the *Unocal* standard. In defending its adoption of company deal-protection measures, a Board must show:

- The Board had reasonable grounds for believing that a threat to company policy and effectiveness existed; and
- The measures adopted were proportional in relation to the threat posed.

If a Board can establish both elements, the action should receive the protection of the business judgment rule.

When a Board elects to pursue a change of control or breakup of the company, the Board has a separate enhanced responsibility: to obtain the highest value reasonably available for shareholders. This standard is commonly referred to as the *Revlon* standard.

Practical Tip: Obtain a Fairness Opinion



Courts give special deference to Boards that seek truly independent third-party advice, such as that of an investment bank, valuation consultant or law firm, to assist disinterested directors in assessing a transaction. An opinion from a reputable third-party financial advisor that a transaction is fair to the company and its shareholders from a financial point of view may substantially reduce the risk of successful challenge to the Board's decision under any standard of review. A fairness opinion can also help independent directors make an informed decision.

Without a fairness opinion, you may find yourself in the unfortunate position of the directors of Trans Union Corporation. In the 1980s, Trans Union's Board approved a sale of the company. In the case *Smith v. Van Gorkom*, a Delaware court held that the Board breached its fiduciary duties by acting without adequate information or independent third-party advice. The court concluded that the Board's decision to accept a market premium without first determining the intrinsic value of Trans Union's shares left the directors vulnerable to personal liability to the company's shareholders to the extent a fair price exceeded the sale price.

By contrast, in 2005 the *Disney* court placed weight on the Disney Compensation Committee's reliance on an independent compensation expert. The Committee was entitled to rely on the expert even though his analysis may have been incomplete or flawed. The Committee had selected the expert with reasonable care, the analysis was within his professional competence, and the directors had no reason to question his conclusions.

Entire Fairness

Entire fairness, the most demanding judicial standard of review, applies when independent directors have not approved or cannot approve a transaction, and the approving directors have a financial

interest in, or other conflict with respect to, a transaction. Transactions are also reviewed for entire fairness when a court finds a breach of the duty of care, or if the Board fails to meet an enhanced scrutiny standard. Under the entire fairness standard, courts conduct a broad substantive inquiry into whether the transaction is fair to the company and its shareholders in light of all the relevant facts and circumstances that existed at the time of the transaction.



**Trap for the Unwary:
Reliance on Experts Is NOT a Safe Harbor –
Keep Your Eyes Open!**

As *Smith v. Van Gorkom* and *Disney* show, a director has traditionally been able to demonstrate good faith and due care by relying on reports prepared by expert advisors to the company, such as bankers and accountants, regardless of the director's personal qualifications. There are limits, however, to the safe harbor for a director who "should have known better."

In the 2004 *Emerging Communications* case, a Delaware court determined that an outside director who, as an investment banker, possessed special expertise, had no right to rely on a fairness opinion of the company's independent investment banker. The court found that the director violated his duties of loyalty and/or good faith in approving a transaction because, given his background, he should have known that the transaction was unfair to minority shareholders. The key take-away:

- Although as a director you may generally rely on a report prepared by a third-party advisor, if you possess special knowledge or skill, you may not "leave it at the door" of the Board room! In your area of expertise, you may be held to a higher standard than your peers.

Board Composition

The composition, size and structure of a public company Board will vary considerably with each company's circumstances. The

Board of an established Fortune 500 company will be different from that of a younger, founder-led technology company. And both of these Boards will differ from that of a family-dominated company.

A well-assembled Board will be diverse. It will include individuals who bring complementary skills relevant to the company's business and objectives. In selecting director nominees, the Nominating & Governance Committee (or the independent directors responsible for nominations) should consider the candidates' financial and business understanding, their industry backgrounds, public company experience, leadership skills and reputation. The Committee should also monitor and consider diversity in geography, race, gender, age and skills.

Every year, a Nominating & Governance Committee (or other independent body) will assess the existing Board's effectiveness in light of evolving company needs, and recommend appropriate nominees to address new circumstances.

Each annual proxy statement will describe which experience, qualifications, attributes or skills of each director led the Board to nominate that person as a director for that business. The proxy will also describe how the Board or the Nominating & Governance Committee considered diversity. If the Board has a diversity policy, the proxy statement will describe how the Board implements the policy and include an assessment of the policy's effectiveness.

Practical Tip:
What Makes a Good Director?
"Noses In, Fingers Out"



Set expectations for your Board members from the outset. Candidates should be ready to devote ample time to learn and give guidance to company officers, while knowing when to stop short of usurping management. An effective director will:

- Learn about the company. Stay informed by visiting physical locations. Ask questions of management. Learn from "informal communication" with others.



Practical Tip:
What Makes a Good Director?
“Noses In, Fingers Out” (Cont’d)

- Review (or, as chair or lead director, develop) agendas and related materials in preparation for Board and committee meetings.
- Attend and actively participate in Board and committee meetings.
- Respond promptly in crisis situations.
- Ask tough, probing questions. Come to each meeting armed with a short list of questions that you expect to have answered.
- Insist on clear and responsive answers.

In short, “noses in, fingers out.”

Independence

Most public company Boards include both inside and outside (or independent) directors. An *independent director* is an individual who can exercise judgment as a director independent of the influence of company management. An independent director will be free from business, family or personal relationships that might interfere with the director’s independence. The NYSE and Nasdaq each require that a majority of directors be independent. Each has its own definition of an independent director, and we discuss these definitions in Chapters 8 and 9. Many institutional investors expect that a “substantial” majority of a company’s directors will be independent.

The three core Board Committees – Audit, Compensation, and Nominating & Governance – will generally consist exclusively of independent directors. Independence standards for Audit and Compensation Committee members are more stringent than those for membership on a Board or other Board committees. The Dodd-Frank Act and Sarbanes-Oxley generally delegate to the NYSE and Nasdaq the rules defining *independence*. And the NYSE and Nasdaq largely leave to Boards the responsibility to determine whether a director is independent.

Board Size

The size of a public company's Board will range from as few as 4 directors to as many as 15 or more, depending on the size and complexity of the company. A company's charter documents may set the size of the Board or allow the Board to set the size, usually within a permitted range.

Larger Boards can provide increased diversity, better continuity and greater flexibility in staffing Board committees with independent directors. But larger Boards have a cost. A group larger than 10 or 12 can prove administratively unwieldy, and reduce each director's opportunity for active and meaningful involvement. Board committees can bridge this gap, and increase the effectiveness of a larger Board.

Board Structure and Director Terms

The corporate laws of most states permit Boards to be divided into two or more *classes* of directors. Directors serving on an *unclassified* Board serve for one-year terms and stand for election at each annual shareholders' meeting. Directors serving on a *classified* or *staggered* Board – one with multiple classes of directors – serve term lengths equal in years to the number of classes of directors.

A company will divide the number of directors assigned to each class as equally as possible. Staggered Boards typically are composed of three classes (the maximum permitted by the NYSE rules and most state corporate statutes), with shareholders annually electing directors of one of the classes to serve three-year terms. This results in staggered termination dates for the director classes, enhancing Board continuity.

Institutional investors generally dislike staggered Boards. Classes reduce flexibility in changing Board membership annually, because directors on a staggered Board typically may be removed only for cause and stand for election only every two or three years. Yet reviewing each class of directors with care every two or three years is a reasonable approach and, as we discuss in Chapter 10, staggered Boards may provide some protection against a hostile proxy contest. Almost 70% of the S&P 500 companies now have declassified Boards or are in the process of eliminating staggered Board terms.



Trap for the Unwary: Shareholder Groups Campaign to Abolish Staggered Boards, Adopt “Majority Voting” and Eliminate Discretionary Broker Voting in Director Election

Institutional investors and their advisors, like Institutional Shareholder Services Inc. (ISS) have encouraged companies to vote to elect all directors annually, and to require *majority* rather than *plurality* voting for directors. Critics contend that annual elections for all directors, together with majority voting, hold directors more accountable every year. In addition, some investors and shareholder activists argue that staggered Boards can limit a target company’s stock value in the takeover bidding process. Although the debate continues, the number of staggered Boards at large public companies has steadily decreased, and shareholder activists are expanding their efforts to target staggered Boards at middle and small cap companies. While 70% of the S&P 500 companies have adopted majority voting for director elections, other companies have adopted corporate governance guidelines that implement a *plurality plus* policy that requires a nominee to tender the nominee’s resignation if the nominee fails to receive a majority vote. Although Boards do from time to time choose not to accept resignations offered by directors who failed to receive a majority vote, this is a controversial decision that a Board should make only after careful thought.

The NYSE has not historically allowed discretionary voting by NYSE member brokers in contested elections of directors. Since 2010, the NYSE has also prohibited discretionary voting by brokers in *uncontested* director elections at shareholders’ meetings. Now, NYSE member brokers may only vote shares with instructions from the beneficial owner of the shares at any company, *regardless of the exchange* on which the company’s stock is listed. Brokers have typically voted in favor of incumbent directors. The prohibition on discretionary voting in uncontested director elections increases the risk that director nominees at companies that have adopted majority voting and plurality plus policies will not receive the needed votes for election.

Some companies have adopted term limits or age restrictions for their directors. Term or age limits can serve as a simple mechanism to bring greater age diversity to a Board and, at times, to remove a noncontributing director. Age limits, however, can cause a qualified director who is making valuable contributions to “age out” just when he or she has the time to devote to serving on the Board and its core committees. Implementing term or age restrictions as nonbinding guidelines, rather than as charter document provisions, can provide greater flexibility.

Board Leadership and Structure

Board leadership rests primarily with the chair and a lead independent director. Increasingly, Boards designate an independent director as chair, or ask an independent director to share Board leadership with an internal chair, usually the CEO. This shared role may be titled *lead director* or *presiding director* (presiding over meetings and executive sessions of independent directors). In recent years, both the number of companies separating the roles of CEO and chair and the number of companies appointing independent chairs have increased. In 2010, approximately 92% of S&P 500 companies had a lead or presiding director, and approximately 19% had an independent chairman. Under the SEC’s proxy rules, a company describes its Board leadership structure in its proxy statement and explains why it believes its structure is appropriate given the company’s specific characteristics or circumstances. Issuers must describe whether and why the company has chosen to combine or separate the Board chairman and CEO positions. If the Board chairman and CEO positions are combined, then the proxy statement will explain whether and why the company has a lead independent director and the specific role the lead independent director plays in the company’s leadership. The proxy will also explain why the company believes its structure is the most appropriate.

Typical duties of the chair include:

- Developing agendas, in consultation with management and other directors, and presiding over Board meetings;
- Interviewing potential director candidates, and coordinating with the Nominating & Governance Committee on director, committee and chair appointments;

- Conducting shareholders' meetings; and
- Subject to any independence limitations, sitting as an ex officio member of Board committees of which the chair is not otherwise a member.

An independent chair's role will also include:

- Chairing regular meetings and executive sessions of independent directors;
- Serving as a liaison between the independent directors and management on sensitive issues, including compensation; and
- Taking the lead in setting short- and long-term goals for management and evaluating progress in meeting expectations.

When the CEO or an inside director serves as the Board chair, many companies designate an independent lead (or presiding) director to coordinate the activities of the independent directors and:

- Work with the chair to develop Board agendas;
- Work closely with the chair and the Nominating & Governance Committee to identify new director candidates;
- Coordinate with the chair regarding information to be provided to the independent directors in performing their duties;
- Chair the regular meetings and executive sessions of independent directors;
- Act as a liaison between the independent directors and the chair; and
- Take the lead in setting short- and long-term goals for the CEO and in evaluating the CEO's performance.

Overboarding

It takes a director many hours to adequately prepare for and attend just one company's Board and committee meetings. Even

talented directors can find themselves overboarded if they sit on more Boards than they can properly serve at one time. Many companies have adopted policies limiting the number of outside Boards on which their CEOs may serve, often setting a limit of one public Board. Although only a small percentage of directors serve on three to six Boards, the number of directors serving on two Boards has risen in recent years, and the number of directors serving on three or four company Boards has remained relatively constant. In recent years, over 80% of directors at S&P 1,500 companies have served on just one public company Board.

Board Meetings and Process

Directors may meet in person or, when appropriate, by telephone or videoconference. When no further material discussion is required, a Board may also act by unanimous written consent in lieu of a meeting. A director's failure to attend at least 75% of the Board meetings (and meetings of any committee on which the director serves) held within a fiscal year will trigger annual proxy statement disclosure – and often, negative votes.

Directors can learn some of their most important information in less formal Board gatherings, such as site visits, retreats with senior management to review company strategy, or other efforts to familiarize directors with the company, its management and corporate governance practices.

The format and frequency of Board meetings will depend on the nature of the company and the powers and duties that the Board delegates to Board committees.

Practical Tip: Understand “Group” Decision Making to Improve Board Behavior



By and large, people will make better decisions as part of a group – so convening a group of intelligent individuals to address tough issues should be an asset of corporate Boards. However, the failures in Board decision making in Enron, WorldCom and other corporate governance scandals appeared to arise, in significant part, through flawed group decision making.



Practical Tip:
**Understand “Group” Decision Making to
Improve Board Behavior (Cont’d)**

Boards can help decision making by understanding that each director will make decisions in a different manner when serving as part of a group than he or she does when acting individually. For example, studies show that responsible and capable people take less responsibility in group settings, in effect becoming “bystanders,” than they would individually. Stress, from time constraints or the importance of a decision, can accentuate human factors that lead to flawed group decision making. Here are some practical steps that Boards can take to avoid the potential pitfalls of group decision making:

- Keep the Board small or use Board committees and executive sessions to minimize “bystanders” by discussing decisions in smaller groups;
- Assign a “devil’s advocate” role to a director or group of directors to analyze the downside of critical decisions;
- Create a nonconfrontational way for newer or more junior members of the Board to make suggestions, raise questions and give their opinions – especially in their critical first year;
- Assign each director an area of focus, on committees or on a task force, in an area of specific concern for the company; and
- Identify anomalies or issues as they emerge and before they become crises.

Regular Meetings of Board

Most Boards schedule 4 to 12 regular meetings a year to review and discuss company activities and to consider various proposals made by Board committees and management. At regular meetings, a Board may:

- Review financial and operating results and business developments;

- Approve fundamental company plans, strategies and objectives;
- Review management performance and approve senior officer compensation packages;
- Meet with auditors and review accounting policies and internal controls;
- Review and approve SEC filings; and
- Evaluate the company's corporate governance practices and the effectiveness of the Board.

Practical Tip:
**Executive Sessions – the Best Things in
(Governance) Life Are Free**



Unlike some more costly aspects of Sarbanes-Oxley, executive sessions of independent directors, as a group or as a committee, serve a vital governance function at virtually no cost. In light of NYSE and Nasdaq mandates requiring executive sessions of nonmanagement and independent directors, companies should adopt a practice of routinely holding executive sessions of independent directors at each Board meeting. The NYSE and Nasdaq have few specific requirements as to the timing, format and substance of executive sessions of nonmanagement directors. An ideal format is to schedule an executive session as the final agenda item at each regularly scheduled Board meeting. Some Boards, however, prefer to break out executive sessions as separate meetings entirely.

The lead director and fellow nonmanagement directors set the tone for these meetings. Before each session, the lead director will develop an agenda based on matters before the regular Board meeting or current pressing concerns. While directors usually do not have authority to make decisions while in executive session, they can reach a consensus and carry the discussion back into the formal Board meeting. A good chair or lead director will work with both management and fellow directors to use executive sessions to address critical Board issues over the course of the year.



Practical Tip:
**Executive Sessions – the Best Things in
(Governance) Life Are Free (Cont'd)**

Executive session proceedings can be informal, sometimes without an agenda. Minutes, if taken at all, generally reflect only the attendees and time of the meeting.

Special Meetings of Board

A Board will also call special meetings to act on important matters such as possible mergers, acquisitions or divestitures, joint ventures or securities offerings or other significant financings.

Board Committees

A strong committee system will allow a Board to function effectively. Sarbanes-Oxley, the NYSE and Nasdaq standards and SEC rules prescribe the existence, composition and many of the activities of the three core committees.

Types of Committees

The three core Board Committees are Audit, Compensation, and the committee variously known as Nominating, Corporate Governance, or Nominating & Governance. All public companies will have an Audit Committee. The NYSE requires, and Nasdaq suggests, an independent director Compensation Committee. The NYSE requires a Nominating & Governance Committee, while Nasdaq requires either a Nominating & Governance Committee or that independent directors meet in executive session to deal with director nominations. (We discuss the NYSE's and Nasdaq's committee requirements in detail in Chapters 8 and 9.)

Audit Committee

Purpose and Authority. The Audit Committee fulfills the Board's oversight responsibilities related to the company's internal controls, financial reporting and audit functions. The Committee is

directly responsible for the appointment, compensation and oversight of the company's outside auditor and may engage independent counsel and other advisors as it deems necessary.

Duties. An Audit Committee has five areas of responsibility:

- *Assess the Independent Auditor.* The Committee selects, determines the compensation, monitors the performance of and, when necessary, replaces the outside auditor. Responsibilities include reviewing the outside auditor's independence, including objectivity and lack of bias. One critical task for the Committee is to preapprove all audit and any nonaudit services (including tax services) that SEC regulations permit the independent auditor to provide.
- *Review Financial Statements.* The Committee reviews annual and quarterly financial statements and financial disclosures. The Committee will discuss with management and/or the outside auditor:
 - Earnings releases and guidance;
 - The MD&A section of the company's periodic reports, including descriptions of critical accounting principles and policies;
 - Management judgments and accounting estimates;
 - Alternative GAAP treatments that the outside auditor has discussed with management;
 - Off-balance sheet structures; and
 - Material communications between the auditor and management, including management letters or disagreements between management and the auditor.
- *Internal Controls and Disclosure Practices.* The Committee has oversight responsibility for internal controls and financial disclosure practices – including overseeing the company's internal audit function. The Committee will review management's and the outside auditor's reports about the company's internal controls, and meet with the company's internal auditors and its Disclosure Practices Committee to evaluate the effectiveness of the company's internal control over financial reporting and disclosure

controls and procedures. The Committee should inquire into and be comfortable with the basis for the certifications of the company's CEO and CFO included in periodic reports filed with the SEC. The Committee may also be responsible for oversight of enterprisewide compliance with the law.

- *Whistleblower Process.* The Committee is the “buck stops here” reviewer for accounting and audit-related whistleblower complaints. The Committee sets procedures for, and receives, retains and treats:
 - Internal and external complaints about accounting, internal accounting controls or auditing matters; and
 - Confidential submissions by employees of accounting and auditing concerns.
- *Risk Oversight.* Boards differ in how much risk oversight the Audit Committee will assume. NYSE-listed Audit Committees need to discuss the guidelines or policies that the company uses to govern the process of risk assessment and risk management. But even under the NYSE, an Audit Committee need not oversee all risk. Instead, a listed company may have a separate risk oversight or other committee or subcommittee to perform the risk oversight function. In that situation, the Audit Committee reviews the risk oversight processes in a general manner, as well as risk assessment and risk management policies.

The Audit Committee has other annual tasks, including self-evaluation and preparing an annual report for the company's proxy statement. As part of the Board's role in setting an ethical tone, the Audit Committee will coordinate with the Board's Nominating & Governance Committee, or a majority of the Board's independent directors, to monitor compliance with the company's:

- Code of ethics for the CEO and senior financial officers (a Sarbanes-Oxley and SEC requirement); and
- Code of Business Conduct and Ethics for employees, officers and directors (an NYSE and Nasdaq mandate).

The Audit Committee defines its duties in a publicly available charter. The Board should approve the charter, and the Committee

should annually review and reassess it. The company then files a copy of its Audit Committee charter with its annual proxy statement at least every three years or makes the charter available on its website.

Composition. The NYSE and Nasdaq require that Audit Committees consist of at least three members. With a few exceptions, all members of the Committee must be independent and financially literate. At least one member should qualify as an *Audit Committee financial expert*. (We discuss the Audit Committee financial expert later in this Chapter).

Independence. Audit Committee members must meet two overlapping independence standards, one established by Sarbanes-Oxley, the other by the NYSE or Nasdaq. The critical requirement of the overlapping standards: no Audit Committee member may be party to any relationship that would interfere with the exercise of his independent judgment in carrying out the responsibilities of a director. (We discuss the NYSE and Nasdaq Audit Committee independence requirements in Chapters 8 and 9.)

Sarbanes-Oxley and implementing SEC rules have only two criteria for Audit Committee independence:

- *No Compensation Other Than for Board Service.* Committee members may not accept consulting, advisory or other compensation from the company or an affiliate of the company, except in the director's role as a member of the Board or a Board committee. This prohibits such indirect payments as payments to spouses or other close family members, or payments to an accounting, consulting, legal, investment banking or financial advisor affiliated with the director.
- *No Affiliate or Affiliated Person.* Committee members may not be affiliates or affiliated persons of the company. An *affiliate* is any person that directly or indirectly controls, is controlled by, or is under common control with the company. An *affiliated person* is a director, executive officer or principal of an affiliate or anyone the affiliate places on the Board to serve as the affiliate's alter ego. The SEC provides a safe harbor to allow a person who owns, directly or indirectly, up to 10% of the company's

outstanding shares to serve on the Committee. Anything above 10% ownership will be tested on a facts-and-circumstances analysis under which the company must answer affirmatively the critical question: “Is he or she a party to any relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director?”

Financial Literacy. Audit Committee members must be able to read and understand fundamental financial statements, including balance sheets and income and cash flow statements.

Audit Committee Financial Expert. SEC rules implementing Sarbanes-Oxley require that companies disclose in their Form 10-Ks (or in a proxy statement incorporated by reference into Form 10-K) the names of one or more members of the Audit Committee who qualify as Audit Committee financial experts. If the Committee does not have at least one Audit Committee financial expert, the company must explain why not in the Form 10-K or proxy statement incorporated by reference.



Practical Tip:
**Audit Committee Financial Expert
Casts a Wide Net**

The SEC has adopted a pragmatic definition of *Audit Committee financial expert*. Investment bankers, venture capital investors, stock analysts and others may qualify, along with finance professionals. An Audit Committee financial expert is a person who has all five of the following attributes:

- Understands GAAP and financial statements;
- Has the ability to assess the application of GAAP to accounting for estimates, accruals and reserves;
- Has experience:
 - Preparing, auditing, analyzing or evaluating financial statements with accounting issues comparable in breadth and complexity to those that can reasonably be expected to be raised in the company’s financial statements; or

**Practical Tip:
Audit Committee Financial Expert
Casts a Wide Net (Cont'd)**



- Actively supervising someone engaged in those activities;
- Understands internal control over financial reporting; and
- Understands Audit Committee functions.

The Board must determine that an Audit Committee financial expert has developed the five attributes through any combination of:

- Education and experience as a CFO, principal accounting officer, controller, public accountant or auditor performing similar functions;
- Experience actively supervising a person in those positions;
- Experience overseeing or assessing the performance of companies or public accountants regarding the preparation, auditing or evaluation of financial statements; or
- Other relevant experience that the Board determines to be adequate (and which it must publicly disclose).

Limitation on Multiple Audit Committee Service. NYSE rules generally encourage Boards to limit their directors to serving on an aggregate of three public company Audit Committees – that is, the company’s plus two others. If an NYSE company does not limit Audit Committee members to serving on three or fewer Audit Committees, the Board must make an annual determination that the simultaneous service will not impair the director’s ability to serve effectively on the Audit Committee. Although Nasdaq imposes no similar limitation, as a practical matter a limit of three is an excellent rule of thumb.



Trap for the Unwary: NYSE and Nasdaq Financial Expertise Requirements

Sarbanes-Oxley and SEC rules allow a company, if it chooses, to disclose that its Audit Committee does not have an Audit Committee financial expert. However, NYSE and Nasdaq rules *require* that the Committee have a member with accounting and financial management expertise (NYSE) or employment experience or other comparable experience resulting in financial sophistication (Nasdaq). A director who meets the Audit Committee financial expert requirements under SEC rules is presumed to satisfy the NYSE and Nasdaq requirements.

Meetings. Many Audit Committees will meet eight or more times per year. For example, a Committee may schedule one in-person meeting every quarter to review the company's proposed earnings release and draft financial statements. The Committee may then follow with a second telephonic meeting in the same quarter to review and comment on the Form 10-Q prior to filing. Many Committees hold another longer meeting or retreat at least once per year, at a time when there is no pressure to review financial statements, to consider:

- Critical accounting policies and practices;
- Internal financial controls; and
- Disclosure practices and procedures.

The Audit Committee's own "annual meeting" is the one at which the Committee approves the Audit Committee's report for the proxy statement, and audited financial statements that will be part of the Form 10-K. At the meeting, the Committee will consider:

- The auditor's report;
- Auditor independence;
- Procedures and other issues related to financial statements and disclosure;
- Management's internal controls report;

- The draft Audit Committee Report to be included in the proxy statement stating the Committee's approval of the financial statements; and
- The appointment of the outside auditor for the new year.

Practical Tip:
**Use Your Audit Committee in
Conflict-of-Interest Situations**



Often, a Board will face a situation requiring action by its independent directors. For example, only disinterested directors should approve a transaction between the company and a director. In fact, Nasdaq requires that the Audit Committee or another committee of independent directors approve related party transactions, and the NYSE advises a similar process. Rather than form a special committee of disinterested directors for each situation, the Board may ask the Audit Committee (or another existing independent committee) to review interested director transactions.

Compensation Committee

Purpose and Authority. A company's Compensation Committee develops criteria and goals for, and then reviews and approves the compensation of, the company's senior management. The Committee also develops and establishes equity and other benefit plans, and may review and establish director compensation. Its charter should provide the Committee sole authority to retain, compensate and terminate consultants and advisors to assist the Committee in fulfilling its responsibilities.

Duties. The Compensation Committee will:

- *Set Goals and Objectives.*
 - Review, approve and evaluate achievement of performance goals and objectives by the CEO and other executive officers in connection with their cash and equity compensation;

- Set compensation levels to motivate management to achieve stated objectives; and
- Align the executives' interests with the long-term interests of the company and shareholders.
- *Establish and Oversee Equity and Benefit Plans.*
 - Establish, administer and review compensatory benefit plans for executive officers and directors and, to a lesser extent, employees generally;
 - Grant or delegate power to grant stock options and restricted stock awards; and
 - Ensure that the plans yield benefits based on performance.
- *Recommend Stock Plan Approval.*
 - Recommend Board or shareholder approval of incentive compensation and equity-based plans.
- *Monitor Compliance With Law.*
 - Monitor the regulatory compliance of benefit plans.
- *Approve Public Disclosure.*
 - Review and approve public disclosure, including the Committee's annual Compensation Committee report to be included in the proxy statement and Form 10-K.

Charter. The Compensation Committee should adopt and periodically review a charter that describes its duties.

Independence. The Compensation Committee should be composed of independent directors. The NYSE requires a committee of all independent directors (at least three), and Nasdaq requires either a committee composed exclusively of independent directors (with a limited exception) or that a majority of independent directors on the Board meet in executive session to perform Compensation Committee duties. The Dodd-Frank Act directs the NYSE and Nasdaq to issue rules defining *independence* for Compensation Committee members. These standards, like those for the Audit Committee, will be more stringent than those for membership on the Board or other Board committees. To preserve independence,

companies will want to avoid interlocking Compensation Committee memberships. An *interlock* occurs when an executive officer of one company:

- Serves on the Compensation Committees of a second entity, one of whose executive officers served on the Compensation Committee of the first company; or
- Serves as a director of a second company, one of whose executive officers served on the Compensation Committee of the first company; or
- Serves as a member of the Compensation Committee of a second company, one of whose executive officers served as a director of the first company.

Interlocks can create an appearance of inappropriate influence and must be disclosed in a company's proxy statement and Form 10-K.

Independence of Compensation Committee members plays a critical role in federal income tax deductibility as well. A Compensation Committee should consist entirely of two or more nonemployee directors to allow the company to maintain deductibility of executive compensation under Internal Revenue Code Section 162(m). (Section 162(m) limits the deductibility of compensation over \$1,000,000 per year, except for performance-based compensation approved by nonemployee directors.) An all-independent director Committee also allows the Committee's approval of option grants to executive officers and directors to qualify as exempt purchases under Rule 16b-3 under the 1934 Act.

Compensation Discussion and Analysis. In the company's annual proxy statement and Form 10-K, the Compensation Committee submits an annual discussion that analyzes and describes the bases for the compensation paid to the CEO and other executive officers. Developing the Compensation Discussion and Analysis (CD&A) is an annual part of the Committee's duties. (We discuss practical tips for drafting the CD&A in Chapter 5.) Smaller reporting companies are not required to provide a CD&A.

Compensation Committee Report. In the company's annual proxy statement and Form 10-K, the Compensation Committee submits an "annual report." In it, the Committee confirms that it

has reviewed and discussed the CD&A with management. Based on that, it recommends that the Board include the CD&A in the company's proxy statement and Form 10-K.

Risk Management and Compensation Policies and Practices. The SEC's proxy rules require companies to assess whether their compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. If so, then the proxy statement will need to discuss the relationship between risk management and the compensation policies and practices for all employees, including nonexecutive officers. (This requirement does not apply to smaller reporting companies.)

Meetings. The Compensation Committee will generally meet at least quarterly. Its "annual" meeting will be held when fiscal year-end results are available to assess how the company's executive officers performed against corporate and personal goals and objectives for that year and to set new goals and objectives for the new year. The Committee will also meet as needed to establish or recommend changes to compensation plans.

Compensation Consultants: Disclosing Fees and Conflicts: A prudent Compensation Committee will retain outside compensation consultants to evaluate compensation for executive officers. The proxy statement will disclose fees paid to compensation consultants, including if a compensation consultant engaged by the Board or Committee provides other services to the company (e.g., benefits or human resources consulting), if the fees for those additional services exceed \$120,000 during the company's fiscal year. The proxy will not need this disclosure, however, if the Board or Committee used different compensation consultants, or when the other services performed by the consultant are limited to providing certain survey data or consulting on broad-based plans for all salaried employees that do not discriminate in favor of executive officers or directors.

The Dodd-Frank Act requires Compensation Committees selecting advisors to consider factors that may affect the advisors' independence, including:

- Does the advisor provide other services to the company?
- What percentage of the advisor's total revenue derives from the company?

- Has the advisor implemented conflict-of-interest policies?
- Is there a business or personal relationship between the advisor and a member of the Committee?
- Does the advisor own any company stock?

As long as the Board takes the appropriate factors into consideration, the Board may choose to engage nonindependent advisors. Companies, however, will disclose in their annual proxy statements, when the Compensation Committee receives advice from a compensation consultant, whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how it was resolved. (The NYSE and Nasdaq may issue exemptions from these provisions for smaller reporting or certain other companies.)

Trap for the Unwary: The Compensation Committee After *Disney*



In 2005, the Delaware Court of Chancery absolved directors of liability for the 1995-96 hiring and firing of former Disney president Michael Ovitz. The Board had approved a severance package for Mr. Ovitz of approximately \$140 million for his 14-month tenure. While not finding Disney's directors personally liable, the court sharply criticized their action (and inaction) as falling short of best corporate governance practices. Many lessons of what not to do, wrote the court, could be learned from the Disney Board's conduct.

- *Engage Your Independent Directors at an Early Stage.* Don't deliver decisions on a silver platter! In *Disney*, half of the Compensation Committee was active in negotiations and the other half came in "very late in the game." Engage your entire Compensation Committee in the "many" early stages of critical employment negotiations.
- *Seek Expert Advice.* In *Disney*, the court allowed the Compensation Committee to rely on an expert, even though the expert's analysis may have been incomplete or flawed, because the Committee selected him with reasonable care, his analysis was



Trap for the Unwary: The Compensation Committee After *Disney* (Cont'd)

within his professional competence, and the directors had no reason to question his conclusions. So make sure your Committee has the authority to solicit advice, and does, from independent employment compensation experts.

- *Provide Directors With Sufficient Notice and a Tally Sheet Prior to the Meeting.* Provide notice and materials well in advance of any meeting at which an executive employment agreement is to be discussed, including:
 - A plain English term sheet summarizing the key provisions of the arrangements (and, when appropriate, a full draft of the proposed agreement).
 - A *tally sheet* or analysis of the cost to the company of termination of employment, change of control, etc., including information relating to reasonableness of terms. Compensation Committee members should expect a spreadsheet making different, alternative assumptions and showing the range of potential payments in the most reasonably foreseeable alternative scenarios that could arise. The court noted that a tally sheet for the Ovitz employment agreement should have shown the cost to Disney if Mr. Ovitz's employment terminated during each of the five years of the agreement's initial term. Show your Board each possible bottom line!
- *Allow Sufficient Time for Discussion and Document the Process.* The *Disney* court focused on the length of Board discussions. Insist that your Compensation Committee spend sufficient time on discussion, and document it! The *Disney* court noted how helpful it would have been had the Compensation Committee minutes shown that the discussion relating to Mr. Ovitz was longer than discussion of other issues.

Trap for the Unwary: The Compensation Committee After *Disney* (Cont'd)



- *Establish Succession Planning.* Mr. Ovitz came to Disney as the result of a too-rapid search precipitated by the unexpected death of Disney's president and the discovery of the then CEO's heart ailment. The Compensation Committee can take the lead to implement a robust succession planning process to keep your company from finding itself in a position where it is forced to hire a CEO without having conducted a proper search or made appropriate preparations.

Nominating & Governance Committee

The Nominating & Governance Committee, third in the triumvirate of "core" Board committees, monitors the Board itself.

Purpose and Authority. The Nominating & Governance Committee takes the lead in selecting directors, committee members and chairs or lead directors. The Committee may also develop corporate governance principles and policies and recommend them to the Board. The Committee should have the ability to retain, compensate and terminate its own advisors, including any search firm used to identify director candidates.

Duties. The Nominating & Governance Committee will:

- *Select the Director Slate.* Identify, evaluate and recommend nominees for directors, and recommend committee members, chairs and lead directors.
- *Oversee Board Governance.* Develop, review and evaluate the effectiveness of corporate governance principles, including director and committee member selection guidelines and procedures and director performance criteria.
- *Develop Meeting Procedures.* Assist the chair or lead director in developing Board meeting practices and procedures.

- *Evaluate.* Periodically evaluate the effectiveness of the Board and coordinate periodic evaluations of Board committees with committee chairs.

Either the Compensation Committee or the Nominating & Governance Committee will:

- Establish director compensation practices; and
- Determine procedures for the selection, review, development and succession of executive officers.

The Nominating & Governance Committee may assist the Audit Committee in monitoring ethical codes. Sarbanes-Oxley provides for a code of ethics for the CEO and senior financial officers, and both the NYSE and Nasdaq mandate a code of business conduct for employees, officers and directors.

Charter. The Board should approve, and the Nominating & Governance Committee should annually review, a written charter describing the Committee's duties.

Composition. Like the Audit and Compensation Committees, the Nominating & Governance Committee should be composed of independent directors. The NYSE requires a Committee of all independent directors (at least three). Nasdaq mandates either a Committee composed exclusively of independent directors (with a limited exception) or that a majority of independent directors on the Board make director nominations.

Director Qualifications and Board Diversity. Companies now disclose, in their annual proxy statements, a description of each director's or nominee's experience, qualifications or skills that qualify that person to serve as a director. These qualifications may include any specific past experience that would be useful to the company, the director's or nominee's particular area of expertise, and why the director's or nominee's service as director would benefit the company. Diversity policies are now also part of proxy statement disclosures, if the Nominating & Governance Committee (or Board) has a policy to consider diversity when identifying nominees. The proxy statement will disclose how the Board implements the diversity policy, and how the Nominating & Governance Committee (or Board) assesses the effectiveness of its policy.

Meetings. The Nominating & Governance Committee will meet periodically to discuss and set governance procedures, to evaluate or select the nominees for election as directors at the annual shareholders' meeting, and to recommend members to the Board. There is no set recommended number of meetings for the Committee.

Practical Tip:
**Mirror, Mirror on the Wall: Does Your Board
Conduct a Self-Evaluation?**



Evaluating the Board and its core committees (Audit, Compensation and Nominating & Governance) on an annual basis has rapidly become a “best practice” for public companies. The NYSE’s listing standards require annual self-evaluations in corporate governance guidelines and committee charters, and many Nasdaq companies conduct evaluations as part of a healthy corporate regimen. No single method has emerged as the “best” evaluation practice. Yet these five practical tips have emerged as consistent guideposts:

- *Choose a Leader to “Own” the Process.* For the Board, this should generally be the chair (if independent), the lead director or the chair of the Nominating & Governance Committee. For evaluating a committee, it will be that committee’s chair. The director responsible for the evaluation process has a number of decisions to make, the discussions are sensitive, and the evaluation needs to get done – all good reasons to entrust the process to one person.
- *Written or Oral – or Both?* The director responsible for the evaluation process should make a threshold decision as to whether the inquiry and the results should be written or oral. Talk to the CEO, Board chair and general counsel, as there are many opinions – and no perfect answers. Often, the questions are written, the evaluation itself is a live interview, and a summary of the results – including how your Board will address any shortfalls – is in writing. Alternative formats include written questionnaires and a single Board or Committee meeting focused on self-evaluation.

Practical Tip:

Mirror, Mirror on the Wall: Does Your Board Conduct a Self-Evaluation? (Cont'd)



- *Assessing the Board as a Whole.* Ask your fellow directors: How is the Board performing its responsibilities of strategic planning, financial and risk oversight, succession planning, executive evaluation and compensation?
- *Individual Director Performance: Independence and Suitability Annually; and Overall Performance Periodically.* The most difficult part of any Board self-evaluation is assessing individual director performance. On an annual basis, the Board needs to make independence assessments and determine suitability of the directors for service on its core committees. A Board could assess individual directors' performances annually, but it is probably sufficient to make these assessments every second or third year as part of a regular re-nomination process.
- *Shortcomings? Address Them – Promptly.* Self-evaluation will almost certainly reveal some shortcomings. Before completing the evaluation process, develop proposed solutions. And ask the director who “owns” the process to report back to the Board at an appropriate time on success in addressing any issues.

Other Committees

Other standing Board committees may include:

- *Risk Oversight Committee.* Because NYSE rules require an Audit Committee to discuss “guidelines and policies to govern the process” by which an NYSE company undertakes risk assessment and management, Audit Committees historically have overseen the company’s risk management function. Companies need not adopt one approach to risk oversight and management,

however. Exchange rules allow companies to establish separate committees or subcommittees to perform the risk oversight function as long as the processes undertaken by the committee are overseen by the Audit Committee. Boards should put in place a risk management system that brings to the Board's attention the most significant risks faced by the company and that allows the Board to understand and evaluate those risks, the relationship among the risks, the effect of the risks on the company and management's ability to handle the risks. The system can consist of a separate committee or subcommittee, or a regular review by the Audit Committee, combined with a periodic review by the full Board. Many companies allocate risk management responsibilities among several committees. This is appropriate so long as the committees coordinate efforts and relay information to one another and the full Board. The company's proxy statement will describe the Board's role in the risk oversight of the company, how the Board administers its oversight function (the Board as a whole? a risk committee? or the Audit Committee?), and the effect that this has on the Board's leadership structure. The proxy will also describe whether the individuals who supervise day-to-day risk management report directly to the Board, or how the Board or committee otherwise receives their input.

- *Finance Committee.* A Finance Committee usually reviews the company's financing policies and procedures, and recommends potential debt or equity financings and similar activities. The Board may also delegate to a Finance Committee the authority to approve certain kinds of transactions when approval is required between regularly scheduled Board meetings.
- *Executive Committee.* An Executive Committee can make decisions for the company on administrative situations or in an emergency, when the full Board is not readily available to act.
- *"Special" Committee of Independent Directors.* The Board may establish a special committee of disinterested directors to evaluate litigation, transactions or other special situations that require arm's-length review. These

situations may include a change of control or assessment of strategic alternatives, shareholder litigation, contracts with or special compensation to a director or a director affiliate, allegations of wrongdoing by a director or an officer, or any other situation in which management or other directors have a conflict of interest.

Board Compensation

Public companies compensate independent directors for Board and committee service with a combination of cash and securities. Some companies also permit their nonemployee directors to participate in company-deferred compensation or other benefit plans. Outside director compensation varies considerably from company to company. Employee directors generally receive limited or no additional compensation for Board service.

In the current environment, with directors serving on fewer Boards and dedicating more time and care to each Board on which they serve, companies have increased director compensation. Directors who assume the highest levels of responsibility, including independent chairs or lead directors, committee chairs and committee members, earn more, in proportion to their responsibilities. The Board or the Nominating & Governance Committee should periodically evaluate the company's director compensation package against peer companies to ask: "Are we competitive? Do we appropriately match rewards to Board effort, risk and results?"

Cash Compensation

Most companies pay their directors an annual cash retainer for Board and committee service. Cash retainers for Board service generally range from about \$25,000 to \$150,000 or more per year. Directors may receive additional compensation for committee service, service as a committee chair or lead director and, often, for meetings. For example, a Board may pay:

- An annual retainer to Board committee chairs;
- An additional retainer to Audit Committee members; and
- Per-meeting attendance fees.

Equity Compensation

Most public companies make initial option or restricted stock grants to directors upon commencement of Board service. Directors then often earn additional grants as part of an annual compensation package. Many public companies pay annual retainers exclusively with equity grants, rather than cash. It is common for initial option or restricted stock grants to be larger and have longer vesting periods (e.g., two to four years), and for annual grants to be smaller and have shorter vesting periods (e.g., one year or immediate vesting).

Practical Tip: Stock Ownership Goals



Does equity or cash compensation provide better incentive to directors without encouraging excessive risk? In the wake of the financial crisis, the debate has intensified.

Some companies believe equity-based compensation may encourage directors to act in ways that may increase the short-term value of their equity stake at the expense of the company's long-term interest. Other companies believe that equity can better align the interests of directors with those of shareholders. These companies may:

- Establish minimum goals (based on a number of shares or dollar amount) for stock ownership by directors;
- Integrate these goals with a compensation plan that allows directors to elect to receive a portion of their annual compensation in stock; and
- Give each director two to five years to achieve the stock ownership goal.



Trap for the Unwary: Hart-Scott-Rodino Filing Requirements

Directors who exercise options for or otherwise purchase large amounts of company stock (in 2011, stock with a value in excess of \$66 million) should be aware of Hart-Scott-Rodino Antitrust Improvements Act of 1976 filing obligations applicable to individuals. Fluctuations in the trading price of a company's common stock could cause the value of a director's holdings to surpass thresholds obligating the director to make a filing with the Department of Justice and the Federal Trade Commission. Failure to make required filings could result in substantial monetary penalties for the individual director and company disclosure obligations.

Liabilities and Indemnification

A public company's directors and officers may be subject to personal liability under statutes relating to employee benefits, tax, antitrust, foreign trade, environmental and securities matters. As discussed above, directors are also liable for breaches of their duties of care, loyalty and candor. To encourage individuals to serve as directors and officers, state laws permit companies to limit director liability and indemnify their directors and officers against some of this exposure.

Limiting Director Liability

Delaware and Model Business Corporation Act states permit charter documents to include *exculpation* or *raincoat* provisions that eliminate the personal liability of a director to the company or its shareholders for monetary damages for some breaches of director duties. However, corporations cannot limit directors' liability in situations that involve:

- Breaches of the duty of loyalty;
- Intentional misconduct or a knowing violation of law;
- Unlawful payment of dividends;
- Transactions from which the director derived an improper personal benefit; or

- Breach of the duty of good faith. (Although not permitted in Delaware, most Model Business Corporation Act states allow a corporation to limit director liability in situations that involve a breach of the duty of good faith.)

Practical Tip:
The Best Way to Limit Liability?
Keep Informed



Even the most robust charter provisions limiting director liability are subject to limitations, particularly in today's dynamic legal and business environment. The most effective way for you as a director to reduce your exposure to fiduciary claims is to:

- Adopt effective corporate governance and compliance procedures;
- Monitor your Board's compliance with those processes; and
- Actively oversee the business and operations of the company.

Actively inquire into and be informed about the corporate decisions that the Board will consider. Use the questions that we suggest in this Handbook. Comply with the duty of loyalty to the company. Create a robust record that demonstrates that you and your fellow directors have met your respective duties of care and loyalty. Do these, and the business judgment rule will generally protect you from personal liability.

Indemnifying Directors and Officers

The corporate laws of nearly all states provide for both mandatory and permissive indemnification of directors and officers, and related rights.

Mandatory Indemnification. A company typically must indemnify every director or officer who successfully on the merits defends an action or claim brought as a result of his or her status as

a director or officer. Some states require the director or officer to be wholly successful on the merits, while other states, including Delaware, provide for mandatory partial indemnification to the extent of the individual's successful defense.

Permissive Indemnification. The corporate laws of most states permit a company to indemnify its directors and officers against expenses incurred in specified actions if they acted in good faith and in a manner they reasonably believed to be in, or not opposed to, the company's best interests. Directors and officers may receive indemnification in a criminal action or proceeding if they had no reasonable basis to believe their conduct was unlawful. However, indemnification usually is not available for actions by the company for amounts paid in settling derivative actions, or when the directors or officers are found to be liable to the company.

Advancement of Expenses. Most states also permit a company to advance defense costs to its directors and officers. State law typically provides that the company may require the director or officer to sign an agreement (an *undertaking*) to repay any advanced amounts if it is ultimately determined that the individual's conduct did not meet the applicable standard of conduct to entitle the individual to indemnification.

Protection Against Subsequent Amendment to Rights. A Delaware corporation may not eliminate or impair a right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw by amending the provision after the act or omission occurs. The one exception to this is that the provision in effect at the time of the act or omission may explicitly authorize the elimination or impairment after the action or omission has occurred.

Indemnification Agreements

It is becoming increasingly common for companies to enter into indemnification agreements with their directors and, less frequently, their officers. To the extent a company's charter documents provide for broad indemnification rights and specifically state that these rights are contractual, indemnification agreements may not seem to provide substantial additional protection. But in reality, an agreement may provide great comfort to directors and

officers. It adds clarity and provides protection against future alterations of charter documents. If any contractual rights are broader than those provided by statute, courts may subject the contract rights to review on public policy or reasonableness grounds.

Directors' and Officers' (D&O) Insurance

Most public companies purchase insurance to cover liabilities arising from their directors' and officers' actions on behalf of the company. D&O insurance provides a potential source of reimbursement to the company for indemnification payments it makes to its directors and officers. D&O insurance may also motivate individuals to serve as directors and officers by reducing their exposure to personal liability from potential gaps in the availability of indemnification and, in situations such as insolvency, where the company cannot adequately indemnify its directors and officers. Most D&O insurance policies include *entity* coverage, which also insures the company directly for its liability on certain defined claims without diluting available coverage for directors and officers.

Practical Tip: Not Yet Public? Add D&O Insurance Coverage Prior to the IPO



D&O insurance coverage is subject to exclusions similar to those that apply under state law to corporate indemnification obligations, including:

- Claims arising out of personal benefits to which the director or officer was not legally entitled;
- Claims arising out of criminal or fraudulent acts;
- Losses arising out of illegal payments to directors and officers; and
- Losses arising out of violations of insider trading laws.

An insurance broker can provide detailed information and recommendations regarding appropriate D&O insurance coverage. Insurance counsel or other experts can also analyze



Practical Tip:
**Not Yet Public? Add D&O Insurance Coverage
Prior to the IPO (Cont'd)**

your company's D&O insurance needs. Liability counsel can advise your company on the terms of D&O insurance coverage, particularly terms relating to retentions and exclusions. The Board should periodically evaluate the coverage to ensure that it continues to meet the evolving needs of your company.

In addition to D&O insurance policies that concurrently cover directors, officers and the company, many companies also purchase supplemental "Side A" coverage that covers only directors and officers. This avoids a claim in a bankruptcy context that D&O insurance proceeds of the general policy are assets of the debtor's estate and are not available to indemnify directors and officers. We provide a visual guide to D&O insurance in Appendix 3.



Practical Tip:
**The Cautious Director: Six Questions to Ask
Your General Counsel Annually**

Help ensure that your company has taken necessary steps to reduce exposure to liability of your company and its directors and officers. Ask your company's general counsel these six questions annually:

- *Do we have a robust system for oversight of enterprise-wide compliance with law? Do we identify and disclose material risks as part of the process for determining the effectiveness of financial controls or the process for certifying financial statements?*
- Who owns this process?
- What is your role in our enterprisewide risk management program?

Practical Tip:
**The Cautious Director: Six Questions to Ask
Your General Counsel Annually (Cont'd)**



- Is there anything about the oversight program that you would improve?
- *Have we established and kept current reliable policies, controls and procedures for gathering, assessing and timely reporting financial and other 1934 Act information and for communicating with investors?*
- *Would you do anything, if you had the authority, to improve our internal financial controls or our disclosure practices and procedures?*
- *Are the terms of our D&O insurance coverage sufficiently broad? What are the limits? Did we negotiate aggressively to expand coverage?*
- *Are our D&O insurance coverage limits high enough? (This question is especially pertinent if your company's market capitalization is growing quickly and might outstrip earlier coverage.)*
- *Would you suggest any changes to our certificate or articles of incorporation and bylaws to provide the maximum liability limitations and indemnification permitted by law?*

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Chapter 8

Governance on the “Big Board”: NYSE Listing Standards

When a company agrees to list its securities on the New York Stock Exchange (NYSE), it agrees to comply with exchange listing standards and rules designed to achieve a high standard of corporate governance and disclosure. While some of these requirements mirror those imposed by the SEC, these requirements are in fact independent obligations with separate ramifications if not met. An NYSE company and its counsel must ensure that the company satisfies both SEC and NYSE requirements.

This chapter reviews listing standards and rules applicable to companies listed on the NYSE, including:

- Initial and continuing listing standards, including mandated corporate governance practices;
- Rules requiring shareholder approvals for certain corporate actions and events;
- Rules requiring NYSE notification regarding certain corporate actions and events; and
- Requirements to publicly disclose specified information in connection with material (or otherwise specified) corporate actions and events.

Listing Standards

The NYSE requires its listed companies to meet quantitative and qualitative standards, both initially and on a continuing basis. Quantitative standards require companies to meet objective financial and share distribution criteria. Qualitative standards relate to companies’ corporate governance and ongoing status.

Initial Listing Standards

A company seeking to list its securities with the NYSE must comply with a set of initial quantitative and qualitative listing standards as a precondition to listing. As set forth in Appendix 4, the NYSE provides some alternatives for meeting initial quantitative listing standards. An NYSE company must also comply with qualitative standards and company-specific considerations, which the company will work through with the NYSE during the initial listing process.



Breaking News: Heightened Requirements for Companies Going Public Through Reverse Mergers

In recent years, listed companies that went public through a reverse merger (where an unlisted operating company merges with a public shell company) have faced more and more public scrutiny and allegations of fraudulent behavior by government officials, the financial press, investors and others, including Nasdaq. In November 2011, the NYSE adopted additional requirements relating to its public-shell, reverse-merger listing applicants. These new requirements are designed to allow time for regulatory and market scrutiny of the company, and for any concerns that would preclude listing eligibility to be identified. Under the new standards, companies formed through a reverse merger with a public shell company generally are eligible for initial NYSE listing only if the combined company has, in addition to satisfying all of the NYSE's other initial listing standards, immediately prior to applying:

- Traded for at least one year on the U.S. over-the-counter market, another national securities exchange or a regulated foreign exchange;
- Timely filed with the SEC all required reports since the reverse merger, including at least one annual report containing audited financial statements for a full fiscal year; and

Breaking News: Heightened Requirements for Companies Going Public Through Reverse Mergers (Cont’d)



- Maintained a closing price of \$4 per share or higher for a sustained period of time, but in no event for less than 30 of the most recent 60 trading days prior to both the filing of its listing application and the date of the company’s listing.

There are some limited exceptions to these additional requirements that can be discussed with your counsel and an NYSE representative if needed.

Continued Listing Standards

The NYSE requires that its listed companies continue to meet minimum quantitative and qualitative standards to remain listed. These quantitative and qualitative continued listing standards are set forth in Appendix 4. A company’s failure to maintain these standards usually triggers NYSE action, which could include initiation of suspension and delisting procedures that may ultimately result in the removal of the company’s securities from trading on the NYSE.

Practical Tip: “Welcome to the Big Board” – Grace Periods if You’re a Newly Listed Company



If you are a company listing with the NYSE at the time of the IPO, you have one year from the listing date to satisfy the requirement that a majority of your Board members be independent. A newly public NYSE company will also be allowed to “phase-in” independent directors on the Audit, Compensation and Nominating & Governance Committees over a 12-month period as follows:

- At least one member of each core Board Committee (Audit, Compensation and Nominating & Governance) must be independent at the completion of the IPO process;



Practical Tip:
**“Welcome to the Big Board” – Grace Periods if
You’re a Newly Listed Company (Cont’d)**

- A majority of the members of each core Committee must be independent (and the Audit Committee must have at least two independent members) within 90 days of listing; and
- All members of each core Committee must be independent (and the Audit Committee must have at least three independent members) within one year of listing.

As a practical matter, however, most IPO companies want to have a majority of independent directors and at least a substantially, if not fully, independent Audit Committee around the time of the IPO in order to meet investor expectations.

For special situations, the NYSE has other rules governing phase-in periods for its corporate governance requirements, including for:

- Companies transferring from another exchange or market to the NYSE (for example, from Nasdaq);
- Companies emerging from bankruptcy; and
- Companies ceasing to be controlled companies or foreign private issuers.

Companies in these circumstances should review with counsel and the NYSE whether phase in periods are available.

NYSE Corporate Governance Standards

The NYSE has established corporate governance standards for its listed companies. These governance standards are designed to bolster public confidence in listed companies, promote prompt public disclosure of material events and enhance corporate ethics and democracy. Compliance with these corporate governance standards is an ongoing condition to listing.

A Majority of Directors Must Be Independent

The NYSE requires a majority of Board members of a listed company to be *independent directors*. For a director to qualify as

independent under NYSE standards, a company’s Board must affirmatively determine that the director has *no material relationship* with the listed company (including any parent or subsidiary in a consolidated group). The Board must consider the materiality of the director’s direct and indirect relationships as a partner, shareholder or officer of any organization with links to the company (including with its senior management). A material relationship can come in many forms, including commercial, industrial, banking, consulting, legal, accounting, charitable, private or familial.

Determinations of director independence are required to be reported by listed companies in their annual meeting proxy statements, together with a description of the direct and indirect transactions, relationships and arrangements between directors and the company considered by the Board in making its independence determinations. Some companies choose to use various general categories of relationships to help in determining director independence and disclose in the proxy statement whether a director had a relationship that fell into one of the categories without going into much additional detail. We discuss general categories of relationships relating to director independence in Chapter 7.

Practical Tip:
**A “Controlled Company” Is Exempt From
Independence and Certain Committee
Requirements**



Are you a *controlled company* – one where more than 50% of the voting power for the election of directors is held by an individual, group or another company? If so, you may choose to be exempted from various NYSE standards relating to director independence and the existence, composition and duties of Compensation and Nominating & Governance Committees.

If you opt to use the controlled company exemption, you will need to include in the SEC filing a description of your controlled company status and a statement that you are relying on the controlled company exemption. A controlled company must continue to comply with the NYSE’s other corporate governance standards, including the requirements relating to an independent Audit Committee and regular executive sessions of nonmanagement (or independent, as the case may be) directors.

What's Independence? The NYSE Describes What It Is Not

A director who has any of the following relationships is not independent under NYSE standards:

- *Employment Relationship.* A director who is or was an employee of the listed company within the past three years, or has an immediate family member who is or was an executive officer of the company within the past three years, will not be independent. Employment as an interim Chairman, CEO or other executive officer will not by itself disqualify the director from being considered independent following that employment.
- *Compensation in Excess of \$120,000.* A director who has, or whose immediate family member has, received more than \$120,000 of direct compensation from the company in any 12-month period within the past three years, other than Board and committee fees and pension or other deferred compensation for prior service (provided the compensation is not contingent on continued service), will not be independent. Compensation that a director receives for past service as an interim Chairman, CEO or other executive officer and compensation that an immediate family member receives for service as a nonexecutive officer employee of the company do not necessarily disqualify the director from being considered independent.
- *Relationships with the Company's Internal or External Auditor.* Any of the following auditor relationships will make a director not independent:
 - Being a current partner or employee of the company's internal or external auditor;
 - Having an immediate family member who is a current partner of the company's internal or external auditor;
 - Having an immediate family member who is a current employee of the company's internal or external auditor *and* personally works on the listed company's audit; or

- Having been, or having an immediate family member who was, a partner or employee of the company’s internal or external auditor personally working on the company’s audit within the past three years.
- *Interlocking Directorate.* A director will not be independent if the director or an immediate family member is or was employed within the past three years as an executive officer of another company (including a charitable organization) at the same time that a current executive officer of the company served on the other company’s Compensation Committee.
- *Significant Business Relationship.* A director will not be independent if the director is a current employee, or an immediate family member is a current executive officer, of another company that made payments to or received payments from the listed company that exceeded, in any of the past three fiscal years, the greater of \$1 million or 2% of the other company’s consolidated gross revenues in the last completed fiscal year.

**Trap for the Unwary:
Watch Those Charitable Contributions!**



Contributions to charitable organizations are among the relationships Boards must evaluate as part of the director independence determination process. In addition, a listed company must publicly disclose contributions made by the company to any charitable organization in which an independent director serves as an executive officer if, within the past three years, contributions in any single fiscal year exceeded the greater of \$1 million or 2% of the charitable organization’s consolidated gross revenues. Some companies adopt a general category of relationships relating to director independence establishing that charitable contributions below a certain dollar amount do not constitute a material relationship for director independence purposes.

Executive Sessions

NYSE companies are required to schedule “regular” executive sessions in which nonmanagement directors meet without management

participation. *Nonmanagement directors* exclude company officers, but may include other directors who may not be independent because of a material relationship or another reason. A listed company may choose to satisfy this requirement by holding regular executive sessions of only its independent directors. However, if a company regularly holds meetings of all nonmanagement directors (and if that group includes any nonindependent directors), then it should also hold an executive session of only independent directors at least once a year. We provide practical tips for organizing executive director sessions in Chapter 7.

The nonmanagement (or independent, as the case may be) directors should either appoint a single presiding director for all executive sessions or rotate the presiding director position following a set procedure. Listed companies that have either an independent chair or a lead independent director usually name this person as the presiding director. Companies are required to publicly disclose the presiding director's name or the procedure by which the presiding director is selected for executive sessions, as well as a method for all interested parties (not just shareholders) to communicate directly with the presiding director or with the nonmanagement (or independent) directors as a group.

Audit Committee

Composition and Independence. NYSE listing standards generally require that a listed company have an Audit Committee consisting of at least three independent directors that meets SEC requirements. All Audit Committee members must meet two somewhat overlapping independence standards, one established by Sarbanes-Oxley, and the other, by the NYSE:

- *Sarbanes-Oxley Criteria.* An Audit Committee member may not receive any payment from the company other than for Board or Committee service or be an affiliated person of the company or any subsidiary. (We discuss these Sarbanes-Oxley independence requirements in detail in Chapter 7.)
- *NYSE Criteria.* An Audit Committee member must be independent under NYSE director independence standards and meet the Sarbanes-Oxley criteria for Audit Committee independence to meet NYSE requirements for Audit Committee independence.

Audit Committee Financial Literacy and Financial Expertise. Each member of the Audit Committee must be, or within a reasonable period of time following appointment must become, *financially literate*. In addition, at least one member must have *accounting or related financial management expertise*. The NYSE does not provide detailed definitions for these concepts. A listed company’s Board is expected to use its business judgment in interpreting these requirements. For example, the Board can presume that a person who meets the SEC’s Audit Committee financial expert standard has the requisite financial expertise to meet the NYSE standards. (We discuss the SEC’s Audit Committee financial expert standard in Chapter 7.)

Practical Tip:

Have Four Qualified Audit Committee Members to Ensure Continued Listing Standard Compliance



As described above, a listed company is required to have at least three qualified independent directors on the Audit Committee. Consider whether it makes sense for your company’s Audit Committee to have a fourth independent Audit Committee member so that your company remains compliant with this NYSE listing standard even when a member unexpectedly resigns (or is removed), without having to scramble to appoint a new member on short notice.

Audit Committee Must Adopt Written Charter. The NYSE requires a listed company to have a written Audit Committee charter that addresses:

- *Purpose.* The core role of an Audit Committee is to help the Board fulfill its duty of overseeing the company’s financial compliance and reporting. It reports on this role in the Audit Committee report in the annual proxy statement. The Audit Committee’s oversight functions cover:
 - The integrity of the company’s financial statements;
 - The company’s legal and regulatory compliance;
 - The independent auditor’s qualifications and independence;

- The performance of both the internal audit function and the external auditor; and
- The preparation of disclosures related to Audit Committee interactions with senior management, the Board and the independent auditors.
- *Duties and Responsibilities.* These include, among others (some of which are discussed in Chapter 7):
 - *Review of the Independent Auditor.* Annually reviewing the independent auditor's performance (including that of the lead partner and the need for rotation of auditor personnel), qualifications, independence and internal quality-control procedures.
 - *Review of Financial Statements and Earnings Releases.* Reviewing and meeting to discuss quarterly and annual financial statements and disclosures with management and the independent auditor, including management's discussion and analysis (MD&A). Reviewing and discussing earnings releases or guidance to analysts and rating agencies. (The NYSE does not specifically require a pre-release review, instead permitting general guidance regarding releases. However, most Audit Committees, or key members, do preview earnings releases and guidance.)
 - *Oversight of Risk Exposure Policies.* Discussing the company's process for setting policies to govern risk assessment and management, including guidelines, policies and major financial risk exposure.
 - *Holding Executive Sessions.* Holding separate and periodic meetings with management, the internal auditor and the independent auditor.
 - *Review of the Audit Process.* Reviewing audit-related problems or difficulties (and management's responses) with the independent auditor.
 - *Informing the Board.* Regularly reporting to the Board on financial statements, compliance with laws and regulations, auditors' performance and audit procedures.
- *Annual Self-Evaluation.* The Audit Committee must annually assess its performance.

Practical Tip:
Audit Committee Should Schedule Additional Meetings or Meet Later in the MD&A Review Process



To comply with NYSE listing standards and governance expectations generally, the Audit Committee must review and discuss a relatively advanced draft of the MD&A to be included in a company’s SEC filing, instead of simply discussing the MD&A disclosure in general. Accordingly, you should have the Audit Committee schedule meetings to allow it to review the MD&A disclosure in a form that is almost ready to be filed. Meetings can be telephonic or in person.

Board Must Evaluate Effectiveness of Director’s Service on Multiple Audit Committees. Does an Audit Committee member serve on more than three public company Audit Committees? If so, the Board must decide whether these commitments impair the director’s ability to serve as an effective Audit Committee member (and publicly disclose its determination).

Internal Audit Function. The NYSE requires each listed company to have an internal audit function. A company may outsource this function to a third party other than its independent auditor.

Compensation Committee

Compensation and Independence. NYSE listing standards generally require that listed companies have a Compensation Committee composed entirely of independent directors, but does not prescribe a minimum number of members.



Breaking News: “Independence Plus” – New Requirements for Compensation Committee Members

The Dodd-Frank Act requires the NYSE and other national securities exchanges to adopt an independence definition specifically for Compensation Committee members. Pursuant to proposed SEC rules to implement this mandate, the new independence definition would likely include the consideration of consulting, advisory or other fees received by a director other than for service on the Board and whether the director is an affiliate of the company.

Compensation Committee Must Adopt Written Charter. The NYSE requires a listed company to have a written Compensation Committee charter that addresses:

- *Purpose and Responsibilities.* In addition to preparing the Compensation Committee report for the annual proxy statement, each Compensation Committee must at least oversee:
 - *CEO Goals, Performance and Compensation.* The Compensation Committee reviews and approves corporate goals and objectives relevant to the CEO’s compensation, evaluates the CEO’s performance in light of those goals and objectives, and determines and sets the CEO’s compensation level based on its evaluation (either as a Committee or with other independent directors as directed by the Board).
 - *Non-CEO Executive Compensation.* The Compensation Committee recommends to the Board non-CEO executive compensation, incentive compensation plans and equity-based plans that are subject to Board approval.
 - *Prepare Disclosure.* The Compensation Committee oversees the preparation of the Compensation Committee report, the Compensation Discussion and Analysis (CD&A) and other related disclosure. (We discuss other duties and responsibilities of the Compensation Committee in Chapter 7.)

- *Annual Self-Evaluation.* The Compensation Committee must annually assess its performance.

Nominating & Governance Committee

NYSE listing standards generally require that listed companies have a Nominating & Governance Committee composed entirely of independent directors, but does not prescribe a minimum number of members. The Nominating & Governance Committee must have a written charter that addresses:

- *Purpose and Responsibilities.* The Nominating & Governance Committee’s principal function is to oversee corporate governance, including, at a minimum:
 - Identifying qualified director candidates consistent with criteria approved by the Board;
 - Selecting, or recommending that the Board select, director nominees for the annual shareholders’ meetings;
 - Developing and recommending to the Board a set of corporate governance guidelines; and
 - Overseeing the evaluation of the Board and management. (We discuss other duties and responsibilities of the Nominating & Governance Committee in Chapter 7.)
- *Annual Self-Evaluation.* The Nominating & Governance Committee must annually assess its performance.

Corporate Governance Guidelines

The Corporate Governance Guidelines required of each listed company allow the Board and senior management to publicly set out the key tenets of their company’s governance values. Prominently featured on the Corporate Governance page of an NYSE company’s website, the guidelines should address:

- Director independence standards, qualifications, responsibilities and compensation;
- Director access to management and independent advisors;

- Director orientation and continuing education;
- Management succession (including selection and contingency policies); and
- Annual evaluation of Board and Committee functioning and performance.

The NYSE calls for website posting of a listed company's Corporate Governance Guidelines, Code of Business Conduct and Ethics and core Committee charters. Companies use website posting both as a way to publicly communicate the "tone at the top" from the CEO and the Board and as a ready reference for employees, directors and shareholders. The annual proxy statement (and other SEC filings) may also remind shareholders that this information is available on the website.

Code of Business Conduct and Ethics

Paired with the Corporate Governance Guidelines is the NYSE-required Code of Business Conduct and Ethics – a practical set of ethical requirements for a listed company's officers, directors and employees. Only the Board or a Committee can waive violations of this code by directors or executive officers, and the company must disclose any of these waivers to its shareholders within four business days of the waiver.

An NYSE-compliant Code of Business Conduct and Ethics will address, at a minimum:

- Conflicts of interest, corporate opportunities and fair dealing;
- Confidentiality and protection and proper use of company assets;
- Compliance with laws, rules and regulations (including insider trading laws); and
- Proactive reporting of any illegal or unethical behavior (with protections against retaliation).

In reviewing a Code of Business Conduct and Ethics, the Board should consider whether the code provides for sufficiently practical and general compliance standards so that the Board or a Committee is not put in a position of regularly considering waivers.

Annual CEO Certification of Compliance With Corporate Governance Standards

A listed company’s CEO must annually certify to the NYSE that he or she is unaware of any (not only material) violation of the NYSE’s corporate governance standards, or detail any known violation. On an ongoing basis, the CEO must promptly notify the NYSE in writing if any executive officer of the company becomes aware of any noncompliance with the NYSE’s corporate governance standards, even if the noncompliance is not material.

NYSE May Issue Public Reprimand Letters

The NYSE may issue a public reprimand letter to a listed company that it determines has violated any NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE standards, the reprimand could lead to trading suspension or delisting.

Website Requirements

Listed companies are required to have and maintain a publicly accessible website. To the extent that the NYSE requires a listed company to make documents available on or through its website, such website must clearly indicate in the English language the location of such documents on the website. Any such documents must be available in printable versions in the English language. A company that becomes listed on the NYSE in connection with its IPO must satisfy NYSE-specified website posting requirements by the earlier of the date the IPO closes or five business days from the listing date.

Shareholder Approval

The NYSE believes that good business practice calls for a listed company’s management to consider submitting to shareholders matters that may be important to shareholders but not necessarily required by law or governing documents. For the following key corporate actions, the NYSE requires shareholder approval:

Equity Compensation Plans

Shareholders must approve any new equity-based compensation plan (or arrangement), whether or not officers and directors can participate in the plan. Shareholders must also approve any material revision to an existing plan.

The NYSE's definition of *material revision* is general, but specifically includes:

- Materially increasing the number of shares available under a plan or expanding the types of awards available under it;
- Materially expanding the class of persons eligible to participate in a plan;
- Materially extending a plan's term;
- Materially changing the method of determining the exercise price of options under a plan;
- Repricing options, including where a plan does not permit repricing or changing a plan to permit repricing or lowering the exercise price after grant; and
- Cancelling options as part of an exchange when the exercise price exceeds the fair value of the underlying security.

The limited number of exemptions from the NYSE's shareholder approval requirements regarding plan approval include: dividend reinvestment or other plans offered to all shareholders, some issuances in connection with mergers and acquisitions, 401(k) and stock purchase plans or similar tax-qualified and parallel nonqualified plans, and equity grants made as a material inducement to a person being newly hired.

If a grant, plan or amendment is exempt from the NYSE's shareholder approval requirements, the Compensation Committee (or a majority of the independent directors) must approve the grant, plan or amendment. In addition, the company must notify the NYSE in writing of use of an exemption and, for any hiring inducement grant, issue a press release to disclose the material terms of the grant.

Practical Tip:
**Be Timely – Apply for Listing of Equity
Compensation Plan Shares**



It is good practice to file an application with the NYSE for listing of reserved, unissued shares in connection with a stock option, stock repurchase or other remuneration plan prior to securities under those plans being issued.

20% Stock Issuance

Shareholders must approve a listed company’s new issuance of common stock (or securities convertible into, or exercisable for, common stock) that would equal or exceed 20% of the outstanding common stock or 20% of the outstanding voting power before the new issuance. A public offering for cash (even if over these 20% limits), however, generally does not require shareholder approval, nor does a private sale of common stock for cash at a price at or above the common stock’s book and market value.

Transactions (Including Issuances) With Related Parties

The NYSE generally requires shareholder approval prior to the issuance of common stock (or securities convertible into, or exercisable for, common stock) of over 1% of the outstanding pre-issuance shares or voting power to:

- Directors, officers or substantial securities holders, or people closely related to these insiders; or
- These insiders’ subsidiaries or affiliates, or entities in which these insiders hold substantial direct or indirect interests.

In addition, the NYSE considers related party transactions to include many listed company transactions with officers, directors or principal shareholders. The NYSE requires appropriate review of related party transactions and recommends, but unlike Nasdaq, does not mandate, that the Audit Committee (or a comparable committee) review these transactions. Following this type of

review, the listed company should determine whether or not a particular relationship serves the best interests of the company and its shareholders and whether the relationship should be continued or eliminated.

The NYSE will review proxy statements and other public filings disclosing related party transactions, and where such situations continue for several years, the NYSE may remind the listed company of its obligation, on a continuing basis, to evaluate each related party transaction and determine whether it should be permitted to continue.

Change-of-Control Transactions

The NYSE generally requires shareholder approval prior to an issuance of securities that would result in a change of control of the listed company.

Additional NYSE Standards

Other critical NYSE standards include:

- *Annual Shareholders' Meetings and Proxy Statements.* Listed companies must hold an annual shareholders' meeting during each fiscal year and solicit proxies and provide proxy materials for all shareholders' meetings.
- *Staggered Boards.* If a listed company has a staggered Board, it may be divided into no more than three classes, with each class being approximately the same in number and serving approximately equal terms of no more than three years. (We discuss staggered Boards in Chapter 7.)
- *Quorum for Shareholders' Meetings.* Generally, a listed company will be expected to have a quorum requirement of a majority of outstanding shares for any meeting of shareholders. Nevertheless, the NYSE may permit quorum provisions of reasonably less than a majority of outstanding shares of common stock if the company agrees to make general proxy solicitations for shareholders' meetings.

Breaking News: NYSE to Adopt Listing Standards That Mandate “Clawback” Policies



The Dodd-Frank Act requires the NYSE and other national securities exchanges to adopt rules requiring listed companies to adopt and implement “clawback” policies to recover incentive compensation paid to executives in the three years preceding a financial restatement that was made due to material noncompliance with financial reporting requirements. The clawback is expected to apply even in the absence of misconduct on the part of an executive. The NYSE has not yet adopted these rules as of November 2011.

Communicate! NYSE Notices and Forms

A listed company’s Investor Relations Officer (IRO) or corporate secretary should maintain close contact with the company’s NYSE representative. At a minimum, the company will need to notify and provide supporting documentation to the NYSE prior to, or at the time of, a number of corporate actions (in addition to those already mentioned), including:

- The listing of additional listed shares or a new class of securities;
- Cash dividends or distributions, or stock splits or stock dividends;
- A material disposition of assets;
- Rights offerings or changes relating to existing shareholders;
- A change in corporate name or change relating to the nature of the business;
- A change in directors or executive officers;
- Record date notice (must be given no later than the tenth day prior to the record date);
- The failure to pay interest on a listed security; and
- A change in auditor, transfer agent, trustee, fiscal agent or registrar.

Disclosure of Material News

In making the disclosure decisions discussed in Chapter 3, a listed company must consider the NYSE's requirement calling for prompt release to the public of any material news that might affect the market for its securities. This obligation exists side by side with those imposed by the SEC and securities laws and results in an affirmative disclosure obligation for NYSE companies that may not otherwise exist.

Material news includes news or information that might reasonably be expected to have a material effect – favorable or unfavorable – on the market of a listed company's securities as well as information that might affect the value of the company's securities or influence an investor's decision to trade in the company's securities. Material news may include earnings announcements, dividend declarations, mergers and acquisitions, tender offers, major management changes and significant new products or contracts. Chapter 3 provides a more detailed list of factors that will help in deciding when news or information merits public release.

Exceptions to Public Disclosure

The NYSE permits a listed company to refrain from announcing even material news if it is necessary and possible for the company to maintain its confidentiality while still keeping all investors on equal footing and allowing no unfair information advantage. However, a company must take extreme care to keep the information confidential, and to remind persons who possess the information of their obligation to refrain from trading on insider information.

If a decision is made not to disclose material news, a listed company's IRO and general counsel's office should closely monitor the price and trading patterns in the company's securities and be prepared to make a public announcement if it becomes clear that the information has leaked to outsiders. If the NYSE detects unusual or suspicious trading activity in a company's securities, the NYSE may contact the company, require that the company make the information public immediately or possibly halt trading in the company's securities until the public has time to absorb the information.

Practical Tip: Those Pesky Rumors – What to Do?



When seeking to maintain the confidentiality of material news, perhaps the greatest threat is a rumor that indicates that the market is aware of the confidential information. In the event of unusual market activity or rumors indicating that investors already are aware of impending company events – for example, a possible acquisition – your company may be required to make a clear public announcement regarding the state of negotiations or the development of corporate plans relating to the rumored information. This may be required even if the Board has not yet considered the matter.

If rumors arise, you should first seek to confirm that the rumor did not originate with the company and, subject to conversations with the NYSE and if considered appropriate, issue the sort of release that we discuss in Chapter 3 (i.e., a release stating that the company’s policy is not to comment on transactional rumors). If the rumors are false, you may need to issue a press release publicly denying or clarifying the false or inaccurate rumors. It is critical, of course, that you not deny negotiations that are in fact occurring and that the statement be otherwise truthful and comply with antifraud laws.

Procedures for Public Disclosure

The NYSE outlines the following steps a listed company should take when publicly releasing material news or responding to rumors:

- If the release is made shortly before the opening or during market hours, the company should telephone the company’s NYSE representative at least ten minutes prior to public announcement and inform the NYSE representatives of the substance and method of distribution of the announcement (when the announcement is in written form, the company must also email a copy of the text of the announcement to the NYSE at least ten minutes prior to release of the announcement);

- Broadly disseminate the news by a Regulation FD-compliant method, and if the information should be immediately publicized then by the fastest available means. If distributed by press release, the NYSE recommends release through Dow Jones & Company, Inc., Reuters Economic Services, Bloomberg Business News, The Associated Press and United Press International, and to newspapers in New York and cities where the company is headquartered or has major facilities;
- Prepare an internal question and answer script, and have someone at the company ready to respond to questions about the material news; and
- Promptly send any press release that may significantly impact trading to the company's NYSE representative.

Trading Halts or Delays

The NYSE requires advance notice of potentially material news in part to determine whether the news would justify a trading halt or delay in the listed company's securities. Companies generally may avoid temporary trading halts or delays related to the release of new material news by fully disseminating the information to the public well before trading begins.

Whenever the NYSE decides to halt or delay trading due to pending material news, it will make an announcement to the market to that effect. Once the company releases the material news, the NYSE will monitor the situation and commence trading pursuant to its normal trading procedures. If the pending material news is not released, the NYSE will monitor the situation and may reopen trading (often within 30 minutes of the trading halt) and signal that material news is still pending.

Chapter 9

To Market, To Market: Nasdaq Listing Standards

Deciding to list on The Nasdaq Stock Market (Nasdaq) brings with it the agreement to follow listing rules designed to achieve a strong standard of corporate governance, but a standard that is more flexible, and accommodating to the needs of less mature companies, than that of the NYSE. For example, Nasdaq provides an *exceptional and limited circumstances* exception permitting a non-independent director to serve on the Audit, Compensation or Nominating & Governance Committee. Larger or more mature Nasdaq companies will want to be familiar with, and consider generally following, NYSE governance standards, as well as the expectations of Institutional Shareholder Services Inc. (ISS) and other monitors of governance standards.

This chapter presents an overview of Nasdaq's listing and corporate governance standards. Nasdaq's requirements often mirror those imposed by the SEC, but are in fact independent obligations with separate ramifications if not met. Nasdaq companies will need to satisfy both sets of requirements.

Listing Standards

Nasdaq imposes both quantitative (financial and public float) and qualitative (corporate governance) listing standards on its listed companies, both on initial listing and on a continuing basis.

Initial Listing Standards

A company electing to list its securities with Nasdaq will be indexed according to a three-tier classification system: The Nasdaq Global Select Market; The Nasdaq Global Market (formerly The Nasdaq National Market); and The Nasdaq Capital Market

(formerly The Nasdaq SmallCap Market). The initial listing standards for each of these markets are different, and are generally based on a company's financial metrics. Nasdaq provides at least three different alternatives for meeting the initial listing standards for each of these markets. These initial listing standards are set forth in Appendix 5.



Breaking News: Heightened Requirements for Companies Going Public Through Reverse Mergers

In recent years, listed companies that went public through a reverse merger (where an unlisted operating company merges with a public shell company) have faced more and more public scrutiny and allegations of fraudulent behavior by government officials, the financial press, investors and others, including Nasdaq. In November 2011, Nasdaq adopted additional requirements relating to its public-shell, reverse-merger listing applicants. These new requirements are designed to allow the Financial Industry Regulatory Authority, Inc. (FINRA) more time to review trading patterns and uncover potentially manipulative trading practices. Under the new standards, companies formed through a reverse merger with a public shell company generally are eligible for initial Nasdaq listing only if the combined company has, in addition to satisfying all of Nasdaq's other initial listing standards:

- Immediately prior to applying, traded for at least one year on the U.S. over-the-counter market, another national securities exchange or a regulated foreign exchange;
- Timely filed with the SEC or other appropriate regulatory authority all required periodic financial reports for the prior year, including at least one annual report containing audited financial statements for a full fiscal year; and
- Maintained a closing price of \$4 per share or higher for a sustained period of time, but in no event for less than 30 of the 60 trading days immediately preceding both the filing of its listing application and Nasdaq's approval of the application.

**Breaking News:
Heightened Requirements for
Companies Going Public
Through Reverse Mergers (Cont'd)**



There are some limited exceptions to these additional requirements that can be discussed with your counsel and a Nasdaq representative if needed.

Continued Listing Requirements

Nasdaq requires that its listed companies continue to meet minimum quantitative and qualitative standards to remain listed. These listing standards are the same for The Nasdaq Global Select Market and The Nasdaq Global Market and are slightly less burdensome for The Nasdaq Capital Market; they are set forth in Appendix 5. A company's failure to meet its listing standards over a specified period of time may trigger a Nasdaq delisting procedure and the removal of a company's securities from the applicable Nasdaq market or a move to a different Nasdaq market.

**Practical Tip:
New to Nasdaq?
A Little Time to Get Up to Speed**



Is your company just going public, or is it transferring from another exchange? If so, you may have a grace period before being subject to some of Nasdaq's corporate governance standards.

IPO Companies. If your company is listing in connection with its IPO, it will be allowed to phase in committee composition requirements. For each of the Audit, Compensation and Nominating & Governance Committees your company forms, your company generally must have:

- One independent member at listing;



**Practical Tip:
New to Nasdaq?
A Little Time to Get Up to Speed (Cont'd)**

- A majority of independent members (and the Audit Committee must have at least two independent members) within 90 days of listing; and
- All fully independent members (and the Audit Committee must have at least three independent members) within one year.

The exceptional and limited circumstances exception, allowing one nonindependent director up to two years of committee service, is at its most useful at the time of an IPO – in part because institutional shareholders may have more patience during the Board’s transition to a truly independent Board – although investor expectations will usually influence the make-up and independence of the Board and its committees at listing. Still, a Board may choose not to form an independent Compensation or Nominating & Governance Committee and instead rely on a majority of independent directors to discharge these Committees’ responsibilities, but either way, a company will be required to meet the majority of independent Board members requirement within one year of listing.

Transferred Companies. For a company transferring from another exchange or market to Nasdaq (for example, from the NYSE to Nasdaq), Nasdaq has special rules governing the phase-in period of its corporate governance requirements. Generally, if the exchange or market from which a company is transferring did not have the same requirements as Nasdaq, the transferring company has one year from the date of transfer in which to comply with the applicable Nasdaq requirements. If the exchange or market from which the company is transferring had substantially similar requirements, the company is afforded the balance of any grace period provided by the other exchange or market (other than for Audit Committee requirements, unless a transition period is available under SEC Rule 10A-3).

Nasdaq Corporate Governance Standards

Nasdaq corporate governance standards parallel the NYSE's standards in many respects, but provide greater flexibility for the less mature company. However, Nasdaq companies find that institutional investors still expect a high standard of corporate governance, sometimes looking with disfavor, for example, on companies that use the exceptional and limited circumstances exception to include a nonindependent director on an otherwise independent Compensation Committee.

A Majority of Independent Directors

A majority of the Board members of a Nasdaq company must be *independent*. The Board itself will annually determine independence – specifically, that directors do not have a relationship with the company that would interfere with their exercise of independent judgment in carrying out their director responsibilities. A company will list the independent directors in its annual proxy statement. A Nasdaq director is not independent if the director has one or more of the following relationships:

- *Employment Relationship.* A director who has been employed by the company within the past three years, or had an immediate family member (as well as anyone residing in the director's home) employed as an executive officer of the company within the past three years, will not be independent. Employment as an interim Chairman, CEO or other executive officer for a year or less will not by itself disqualify a director from being considered independent following the employment.
- *Compensation Over \$120,000.* A director who has, or whose immediate family member has, received over \$120,000 in compensation from the company, other than compensation for Board or committee service or for employment as an interim executive officer (for one year or less) or other amounts that are generally non-compensatory in nature, in any 12-month period within the past three years, will not be independent.
- *Relationships With the Auditor.* A director who is or has an immediate family member who is a current partner of the

company's independent auditor, or was a partner or employee of the company's independent auditor and worked on the company's audit at any time during the past three years, will not be independent.

- *Interlocking Directorate.* A director who is or has an immediate family member who is a current executive officer of another company where, at any time during the past three years, an executive officer of the company has served on the other company's Compensation Committee will not be independent.
- *Significant Business Relationship (Including Nonprofits).* A director who is or has an immediate family member who is a current partner, executive officer or controlling shareholder of an entity, profit or nonprofit, to which the company made, or from which the company received, payments in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues or \$200,000, whichever is more (other than payments arising solely from investments in the listed company's securities or payments under nondiscretionary charitable contribution matching programs), will not be independent.

Nasdaq provides a cure period for a listed company's failure to comply with the independent majority requirement either if one director ceases to be independent for reasons beyond the director's reasonable control or in the case of a single vacancy on the Board. The cure period ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance. However, if the next annual shareholders' meeting is less than 180 days after the event that caused the noncompliance, the company will instead have 180 days to regain compliance. The company must notify Nasdaq immediately upon learning of the noncompliance.

Practical Tip: Controlled Companies Are Exempt From Independence Requirements



Does an individual, group or other entity own more than 50% of the voting power of your company's securities? If so, your company may be a *controlled company* that does not need to have:

- A Board consisting of a majority of independent directors; or
- Independent Compensation and Nominating & Governance Committees (or independent directors making compensation and nomination decisions).

A controlled company must continue to comply with Nasdaq's requirement for an independent Audit Committee and other Audit Committee rules. And the independent directors must hold regular executive sessions. Otherwise, Nasdaq's corporate governance burdens are reduced. A controlled company must disclose its controlled company status in its annual proxy statement, as well as explain the basis for its status.

Mandatory Executive Sessions of Independent Directors

Independent directors must meet "regularly" in executive sessions, without management or other directors present. Nasdaq contemplates at least two executive sessions each year. (We discuss executive sessions in further detail in Chapter 7.)

Audit Committee

Composition. Each Nasdaq company must have an Audit Committee consisting of at least three directors, all of whom must be independent. All Audit Committee members must be *financially literate* and at least one member must be *financially sophisticated*. (We discuss these requirements later in this chapter.) Directors who have participated in the preparation of the financial statements of the company or any current subsidiary of the company during the past three years cannot serve on the Audit Committee.

Heightened Independence Requirements for Audit Committee Members. In addition to Nasdaq’s general independence requirements discussed above, Audit Committee members must satisfy the Sarbanes-Oxley Audit Committee independence requirements. Under these SEC Rule 10A-3 requirements, Audit Committee members cannot:

- Receive any payment from the company other than for Board or committee service; or
- Be an affiliated person of the company or any subsidiary. (We discuss these Sarbanes-Oxley independence requirements in Chapter 7.)

Exceptional and Limited Circumstances Exception to Audit Committee Independence Requirements. A director who does not satisfy Nasdaq’s general independence standards for directors, but who does satisfy the Sarbanes-Oxley Audit Committee independence requirements, and who is not a current officer or employee, or an immediate family member of a company employee, can serve on the Audit Committee for up to two years.

The company must disclose the nature of the director’s relationship, and the reasons for the Board’s determination that the director’s service on the Audit Committee is in the best interests of the company and its shareholders, in the company’s annual proxy statement. Only one director may be appointed under this exception at one time and, if so appointed, may not serve as the Audit Committee chair.

Trap for the Unwary:



Use Exceptional and Limited Circumstances Exception From Independence With Great Care

Nasdaq permits a director who is not independent under Nasdaq criteria to serve on an Audit, Compensation or Nominating & Governance Committee for up to two years under its exceptional and limited circumstances exception, but Boards should be aware of important limits to this exception’s usefulness.

**Trap for the Unwary:
Use Exceptional and Limited Circumstances
Exception From Independence With Great Care
(Cont'd)**



First, take the temperature of your shareholders before using this exception. Many institutional investors look with great disfavor on nonindependent core Committee members, particularly for the Audit and Compensation Committees. They may let you know that they will vote against those directors or against an entire Board slate that uses the exception without a very good reason.

Second, separate and apart from Nasdaq, various regulations may make it cumbersome to use this exception. For example, Sarbanes-Oxley requires all public company Audit Committee members to be independent under the Sarbanes-Oxley definition. As we detail in Chapter 7, Sarbanes-Oxley has only two simple criteria for independence (but they do cover many potential relationships): no compensation from the company whatsoever other than for Board service and no affiliate status, i.e., a director who controls, is controlled by, or is under common control with the listed company (or an officer or director of another company that is an affiliate of the listed company). Also, regarding the Compensation Committee, the usual desire under the Internal Revenue Code and the 1934 Act to have “outside directors” and “nonemployee directors” approve certain compensation arrangements and option and share grants makes a Compensation Committee far more practical than having all of the independent directors act as a group on compensation. Further, as we discuss in Chapter 5, the Dodd-Frank Act requires enhanced executive compensation disclosure as well as a shareholder vote on executive compensation (Say-on-Pay), and an independent Compensation Committee gives shareholders additional comfort regarding a company’s compensation practices and may help a company avoid an unfavorable Say-on-Pay shareholder vote.

Companies Can “Cure” Inadvertent Noncompliance With Nasdaq’s Audit Committee Composition Requirements. Nasdaq provides a cure period if a company fails to comply with the Audit

Committee composition requirements because one director ceases to be independent for reasons beyond the director's reasonable control or because of a single Board vacancy. If the failure to comply is due to reasons beyond the director's reasonable control, the cure period ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance. If the failure to comply is due instead to a single Board vacancy, then the cure period also ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance, except that if the next annual shareholders' meeting is less than 180 days after the event that caused the noncompliance, the company will instead have 180 days to regain compliance. The company must notify Nasdaq immediately upon learning of the noncompliance. Nasdaq will excuse only a single noncomplying Committee member from meeting the Nasdaq independence requirements, and the director must at all times meet Sarbanes-Oxley's Audit Committee independence requirements.

Financial Literacy and Sophistication. Audit Committee members must be able to read and understand fundamental financial statements, including balance sheets and income and cash flow statements, at the time of their appointments. In addition, at least one member of the Audit Committee must have *financial sophistication*. Although Nasdaq did not expressly adopt the SEC's Audit Committee financial expert standard, any director who meets that standard will meet Nasdaq's financial sophistication standard. (We discuss the SEC's Audit Committee financial expert standard in Chapter 7.) Financial sophistication may result from past employment experience in finance or accounting, requisite professional certification in accounting or other comparable experience or background, including being or having been a CEO, CFO or other senior official with financial oversight responsibilities.

Audit Committee Charter. A Nasdaq-compliant written Audit Committee charter will detail the responsibilities and authority of the Audit Committee, including those established in SEC Rule 10A-3. Nasdaq rules call for a charter that requires the Audit Committee to:

- ***Oversee Outside Auditors.*** Be directly responsible for the appointment, compensation, retention and oversight of the outside auditors.

- *Preapprove Outside Audit Services.* Preapprove all permissible services provided by the company's outside auditors.
- *Set Procedures for Financial Whistleblower Complaints.* Establish procedures for the receipt, retention and treatment of complaints to the company regarding accounting, internal accounting controls or auditing matters, and for the confidential, anonymous submission by employees of accounting or auditing concerns.
- *Retain Advisors.* Be authorized to engage, and determine funding for, independent legal counsel and other advisors. (We discuss other common duties of the Audit Committee in Chapter 7.)
- *Receive Adequate Funding to Meet Responsibilities.* Be provided with appropriate funding from the company for payment of compensation to auditors, independent legal counsel and other advisors, and ordinary administrative expenses necessary or appropriate to carry out the Audit Committee's duties.

Audit Committee Reviews and Oversees Related Person Transactions

A Nasdaq company's Audit Committee (or a comparable body of independent directors) must review and oversee all related person transactions for potential conflict of interest situations on an ongoing basis. In order to be consistent with proxy disclosure, defines *related person transactions* as those described in Item 404 of Regulation S-K. These transactions include those in which the company is a participant that involve over \$120,000 and in which any director or nominee, executive officer or 5% or more shareholder, or any immediate family member of the foregoing, has a direct or indirect material interest. (We discuss related person transactions in more detail in Chapter 5.)

Compensation Committee (or Compensation Decisions by Independent Directors)

An independent Compensation Committee or a majority of the independent directors must determine, or recommend to the Board for determination, compensation for the CEO and other executive officers. The CEO may not be present during voting or deliber-

ations concerning CEO compensation. Under the exceptional and limited circumstances exception, one nonindependent director can serve for two years on an independent Compensation Committee.



Breaking News:
**“Independence Plus” – New Requirements for
Compensation Committee Members**

The Dodd-Frank Act requires Nasdaq and other national securities exchanges to adopt an independence definition specifically for Compensation Committee members. Pursuant to proposed SEC rules to implement this mandate, the new independence definition would likely include the consideration of consulting, advisory or other fees received by a director other than for service on the Board and whether the director is an affiliate of the company.

***Nominating & Governance Committee (or Nominations by
Independent Directors)***

The third core independent Board Committee of a Nasdaq company is the independent Nominating & Governance Committee. As with the Compensation Committee, the Board may forgo the Nominating & Governance Committee and choose instead to act by a majority of independent directors. The Nominating & Governance Committee (or majority of independent directors) will select, or recommend to the Board for selection, all director nominations, except for those Board “seats” where a third party has the contractual or other right to nominate a director. The Board may use the exceptional and limited circumstances exception for service by one nonindependent director.

A Nasdaq company with a Nominating & Governance Committee will need to have its Board adopt a formal written charter covering at least the nomination process. If instead the Board acts by having a majority of independent directors make nomination decisions, then a comparable Board resolution should address the nomination process.

Companies subject to a pre-November 2003 agreement governing the nomination of directors that contains provisions inconsistent with the Nasdaq standards are not required to comply with these requirements until the agreement expires.

Exceptional and Limited Circumstances Exception to Compensation Committee and Nominating & Governance Committee Independence Requirements.

The exceptional and limited circumstances exception is available if:

- The Committee has at least three members;
- The nonindependent director is not an officer or employee of the company or an immediate family member of an officer or employee of the company;
- The Board determines that the nonindependent director's service on the Committee is in the best interests of the company and its shareholders;
- The company discloses in its annual proxy statement the nonindependent director's relationship to the company and the basis for the Board's determination; and
- The member appointed under this exception serves no longer than two years.

Code of Conduct

A core component of a Nasdaq company's good governance framework is to adopt and make publicly available a Code of Conduct that covers all its directors, officers and employees. Nasdaq requires that the Code of Conduct be in compliance with the *code of ethics* that Sarbanes-Oxley requires. Item 406 of Regulation S-K defines this code of ethics as written standards reasonably designed to deter wrongdoing and to promote honest and ethical conduct. The Code of Conduct must include enforcement mechanics, and the Board must approve any waivers from the Code for directors or executive officers. Waivers must be disclosed to shareholders within four business days.

Notification of Noncompliance With Nasdaq Corporate Governance Rules

A Nasdaq company must promptly notify Nasdaq if an executive officer of the company becomes aware of any noncompliance by the company with Nasdaq's corporate governance standards.

Shareholder Approval

Nasdaq requires shareholders to approve specified key corporate actions by a majority of the votes cast.

Stock Compensation Plans. Nasdaq requires that shareholders approve both new equity-based compensation plans or arrangements, whether or not officers and directors can participate, and material amendments to those types of existing plans or arrangements.

Nasdaq defines a *material amendment* to include:

- Material increase in the number of shares available under the plan, other than increases to reflect reorganizations, stock splits, mergers, spin-offs and similar transactions;
- Material increase in the benefits available to plan participants;
- Material expansion of the class of persons eligible to participate in the plan;
- Any expansion in the types of awards provided under the plan;
- Material extension of the plan's term;
- Reduction in the price at which shares or stock options may be offered; and
- The repricing of stock options, where the plan does not specifically permit the repricing.

There are a variety of special purpose exemptions to these shareholder approval requirements. These include exemptions for warrants or rights offered generally to all shareholders (poison pills), stock purchase plans available on equal terms to all shareholders (dividend reinvestment plans), awards in connection with mergers and acquisitions, tax-qualified, nondiscriminatory employee benefit plans and parallel nonqualified plans (like 401(k) plans or other ERISA plans), and "hiring bonus" grants of options or stock used as a material inducement to a person's initial employment with the company. Even when a plan or an arrangement is exempt from shareholder approval requirements, Nasdaq still requires that the Compensation Committee (or a majority of independent directors) approve inducement grants and

tax-qualified, nondiscriminatory employee benefit and parallel nonqualified plans. In addition, the company must promptly disclose in a press release the material terms of inducement grants made in reliance on the shareholder approval exception.

20% Stock Issuance (5% to Affiliates in an Acquisition)

Shareholders of Nasdaq companies have long been required to approve a major additional issuance of common stock (or convertible securities). This is the provision that generally triggers a shareholder vote and proxy solicitation on significant stock-for-stock mergers.

20% Rule. Shareholders must approve any issuance (other than in a public offering) that may exceed 20% of the outstanding common stock or the outstanding voting power, if the issuance is priced below the greater of the stock's book or market value (sales by officers, directors and 5% shareholders will be combined with the company's issuance in determining whether the 20% threshold has been met). Nasdaq also requires shareholder approval for any acquisition that results in the issuance of common stock (or convertible securities) of 20% or more of the outstanding common stock or the outstanding voting power (and this acquisition-related approval triggers a vote regardless of the price of the Nasdaq purchaser's common stock).

5% Affiliate Acquisition Rule. A Nasdaq acquirer must also seek shareholder approval of an acquisition that results in the issuance of over 5% (by number of shares or voting power) of outstanding common stock if a director, executive officer or 5% shareholder of the acquirer has a 5% (or those insiders together have a 10%) interest in the target.

Change-of-Control Transactions. Nasdaq requires shareholder approval for issuances or potential issuances of securities resulting in a change of control of the company.

Additional Corporate Governance Standards

Nasdaq companies must comply with a number of additional governance standards. Four critical ones are:

- **Registered Auditor.** Nasdaq requires a company to be audited by an auditor registered with the Public Company Accounting Oversight Board (PCAOB).

- *Annual Shareholders' Meeting.* Nasdaq requires a company to hold an annual shareholders' meeting within one year of its fiscal year-end and to provide notice to Nasdaq of the meeting (which notice requirement can be met through applicable SEC filings).
- *Quorums.* Nasdaq prohibits quorum provisions that require less than one third of all outstanding shares of common voting stock.
- *Solicitation of Proxies.* Nasdaq requires a company to solicit proxies, provide proxy statements for all shareholders' meetings and send copies of the proxy solicitation to Nasdaq (which copies requirement can be met through applicable SEC filings).



Breaking News: Nasdaq to Adopt Listing Standards That Mandate "Clawback" Policies

The Dodd-Frank Act requires Nasdaq and other national securities exchanges to adopt rules requiring listed companies to adopt and implement "clawback" policies to recover incentive compensation paid to executives in the three years preceding a financial restatement that was made due to material noncompliance with financial reporting requirements. The clawback is expected to apply even in the absence of misconduct on the part of an executive. Nasdaq has not yet adopted these rules as of November 2011.

Keep Nasdaq Informed! Notices and Forms

Nasdaq asks that listed companies notify, and provide supporting documentation to, Nasdaq and, in some cases, file a Listing of Additional Shares form, at or prior to many corporate actions, including the following:

- Establishing or materially amending a stock option plan, purchase plan or other equity compensation arrangement under which stock may be acquired by officers, directors, employees or consultants without shareholder approval;

- Issuing securities that may potentially result in a change of control;
- Issuing common stock or securities convertible into common stock in connection with the acquisition of another company, if any officer, director or 5% shareholder of the issuing company has a 5% or greater interest (or if such persons collectively hold a 10% or greater interest) in the target company or the consideration to be paid;
- Entering into a transaction that may result in the potential issuance of common stock (or convertible securities) greater than 10% of the outstanding common stock or the outstanding voting power on a pre-transaction basis;
- Declaring a dividend or stock distribution;
- Reclassifying or exchanging securities or changing the par value of stock;
- Undertaking a reverse stock split;
- Reincorporating;
- Causing any change in the number of outstanding shares greater than 5%;
- Changing the company's general character or nature of business, address of principal executive offices or corporate name; or
- Changing the transfer agent or registrar.

At its discretion, Nasdaq may request any additional documentation, public or nonpublic, it finds necessary to consider a company's continued listing.

Disclosure of Material News (Tell Nasdaq First)

Nasdaq, like the NYSE, generally requires a listed company to promptly and publicly disclose any material news or information that might affect the market for its securities. This obligation exists side by side with SEC and securities law obligations, and results in an affirmative company disclosure obligation – with a variety of exceptions.

Material news includes information that would reasonably be expected to affect the value of a company's securities or influence an investor's decision to trade in the company's securities. Categories of material news are very broad; generally, all significant events affecting the company, including its business, products, management and finances, presumably merit prompt public disclosure.



Practical Tip: What's Material News?

Nasdaq provides examples of material news, similar to the SEC's list of possibly material information that we set out in Chapter 3, that serves as a useful guide for determining whether news merits public disclosure. Nasdaq companies must notify Nasdaq's MarketWatch Department usually at least ten minutes prior to the release of the following types of material information:

- Financial disclosures, including quarterly and yearly earnings, earnings restatements, pre-announcements and earnings guidance;
- Corporate reorganizations and acquisitions, including mergers, tender offers, asset transactions and bankruptcies or receiverships;
- New major products or discoveries, or significant developments regarding customers or suppliers;
- Senior management changes of a material nature or a change of control;
- Resignation or termination of independent auditors, or withdrawal of a previously issued audit report;
- Events regarding the company's securities, for example, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders or public or private sales of additional securities;

Practical Tip:
What's Material News? (Cont'd)



- Significant legal or regulatory developments; and
- Any event requiring the filing of a Form 8-K.

Chapter 3 provides a list of other factors that may help your company determine when news merits public disclosure.

Exceptions to Nasdaq's Disclosure Requirements

The exceptions to Nasdaq's disclosure requirement soften the general mandate to always promptly publicly disclose material news. A listed company may delay announcement of material news, if it is both necessary and possible for the company to maintain its confidentiality, and so long as no investor has an unfair information advantage. To take advantage of this, a company must keep the information confidential and remind persons who possess the information of their obligation to refrain from trading on insider information.

The IRO and other responsible officers of a listed company will also need to closely monitor the trading of its securities for unusual price or volume movements, and be prepared to make a public announcement if it becomes clear that confidential information has leaked. If Nasdaq detects unusual or suspicious trading activity in a company's securities, Nasdaq's MarketWatch Department may contact the company and require that it promptly and publicly disclose the information. In this case, Nasdaq may require a trading halt in the company's securities until the public has time to absorb the information.



Practical Tip:
Rumors: Where There's Smoke – Don't Get Burned!

Your Nasdaq company needs to carefully guard confidential information to prevent rumors that originate from company sources from circulating. Nasdaq specifies that if unusual market activity or rumors indicate that investors are aware of impending events, the issuer may be required to make a clear public announcement regarding the state of negotiations or the development of corporate plans in the rumored area. This disclosure may be required even if your Board has not yet taken up the matter for consideration.

If the rumors are false, the company may need to issue a press release publicly denying or clarifying the false or inaccurate rumor. This statement must obviously be truthful and not omit material information necessary to prevent the disclosure from being misleading.

Because a premature public announcement, including that triggered by rumors, can jeopardize proposed plans, careful monitoring of confidential information, and of rumor, can protect a critical corporate initiative.

Procedures for Public Disclosure

Nasdaq permits its listed companies to disclose material information through any Regulation FD-compliant method. These methods include press release and Form 8-K, as well as conference call, press conference and webcast, provided that the public is given adequate notice (generally by press release) and access. (We provide practical tips for making Regulation FD-compliant disclosures in Chapter 3.)

Nasdaq requires a listed company to notify Nasdaq's Market-Watch Department usually at least ten minutes prior to the release of material information included in its list of material events. (See the list in the "What's Material News?" Practical Tip earlier in this chapter.) For material disclosure not in the form of a press release

or Form 8-K, companies should provide prior notice in a press release announcing the logistics of the future disclosure and a descriptive summary of the information to be announced. Nasdaq encourages companies to provide prior notice of material news disclosures, even if not mandated, whenever the company believes, based on its knowledge of the significance of the information, that a temporary halt in trading may be appropriate. Nasdaq's Market-Watch Department is required to keep nonpublic information confidential and use it only for regulatory purposes.

Trading Halts

Nasdaq requires advance notice of disclosures in part in order to determine whether the material news justifies a trading halt in a company's securities. A listed company can generally avoid a trading halt by broadly issuing the disclosure to the public an adequate time prior to market open or after trading hours.

When an issuer makes a significant announcement during trading hours, the exchange may require a trading halt to allow investors to gain equal access to information, fully digest the material news and understand its impact. A trading halt also alerts the market that material news has been released. Nasdaq determines when a trading halt is necessary and how long it should last, usually permitting trading to resume within 30 minutes after news is fully disseminated.

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Chapter 10

Corporate Structural Defenses to Takeovers

Many private companies aspire to go public. Benefits of an IPO include the acquisition of capital for growth and the provision of liquidity to shareholders. At the same time, third parties may seize opportunities presented by public capital markets to acquire control of public companies. Vulnerability to unsolicited and sometimes hostile takeover attempts, as well as attempts to influence corporate decision making, can mark the beginning of the end for management and its long-term goals for the company.

Potential acquirers employ a range of techniques to acquire public companies. Changes of control can result from friendly negotiated acquisitions or hostile takeover attempts. Some of these techniques essentially coerce shareholders of the target company into accepting the takeover proposal. Hostile takeovers accompanied by coercive tactics therefore result in enormous stress both for target companies and their shareholders. For example, in the *two-tier* or *front-end loaded* tender offer, the tender offeror makes a cash offer to a target company's shareholders for less than all the outstanding shares of the company. This creates an incentive to those shareholders to tender their shares for cash in the first stage of the tender offer in order to avoid being forced to accept a lesser amount of cash or different consideration later.

Although a public company can defeat a takeover attempt after it has begun, a Board should prepare for coercive takeover efforts well before these situations arise.

Why Adopt Corporate Structural Defenses?

The Board oversees the development and implementation of the company's business goals and strategies. By equipping the company

with tools to withstand coercive takeover efforts, the Board enhances the ability of the company to accomplish its strategic objectives. In particular, the Board may implement appropriate corporate structural defenses by amending the company's certificate or articles of incorporation or bylaws. Although standard takeover defenses will not prevent a well-financed takeover that is in the best interests of shareholders, these defenses will generally provide a target company's Board with sufficient time and negotiating leverage to allow it to:

- Evaluate an offer;
- Communicate with shareholders;
- Negotiate with a potential buyer to preserve the company's long-term objectives and /or achieve the best available price for the company's shareholders; and
- Otherwise maximize shareholder value.

While our discussion uses concepts from Delaware law, similar defenses are permitted by most other states.



Practical Tip: An Ounce of Prevention

Your Board should consider structural takeover defenses well before the company confronts a takeover attempt. It is important for the Board to consider corporate structural defenses in a reasoned fashion, rather than in the heat of a takeover battle. Implementing some defenses may require considerable lead time (for instance, shareholder approval may be required). Structural defenses put in place after a takeover attempt has been initiated will, if challenged in court, receive significantly closer judicial scrutiny than those defenses established prior to a takeover attempt. The Board should also routinely reexamine the company's existing corporate structural defenses in order to keep pace with changes in applicable law, as well as the increasingly refined approach of activist and institutional shareholders.

Why Not Adopt Structural Defenses?

Institutional shareholders often object to corporate structural defenses because they view these defenses as entrenching existing

management and denying shareholders the benefit of potentially valuable offers for corporate control. Institutional Shareholder Services Inc. (ISS) and other institutions have identified the following practices that increase the concerns of governance-related risk:

- Staggered Board;
- Blank check preferred stock;
- Super-majority shareholder approval of significant business transactions and amendments to certificate or articles of incorporation and bylaws; and
- Non-shareholder-approved shareholder rights plans.

Staggered Boards

A staggered Board, which is discussed in Chapter 7, may impede some takeover attempts. Under Delaware law, shareholders may remove directors of a company with a staggered Board only for cause. If a company has three classes of directors, then, in the absence of cause, shareholders can replace no more than one-third of the directors in any one year.

Staggered Board terms prevent hostile acquirers from taking control of the company by replacing the entire Board at one time. This structure may deter certain types of takeover tactics, including proxy fights and tender offers for less than all of a company's shares. A staggered Board alone will not usually deter an *any-and-all* cash tender offer – an offer made to all the shareholders to buy all their shares at the same price – since most Board members will not oppose an offeror that has acquired a majority of the company's shares. In general, the use of a staggered Board, combined with a shareholder rights plan and a strong state antitakeover statute, can delay an any-and-all cash tender offer until the acquirer obtains majority control of the Board.

Supermajority Removal Provisions

If a company declines to implement a staggered Board, it may otherwise limit shareholders' ability to remove Board members. For example, the company may amend its certificate or articles of incorporation so that the percentage vote of the shareholders required for removal of a director is increased from a simple majority to 75% or 80%.



Trap for the Unwary: Don't Go Overboard

If the Board itself wishes to remove a poorly performing director before his or her term has expired, a staggered Board could make removal extremely difficult.

Filling Vacancies on the Board

In the absence of a staggered Board, a company may create a structural defense by amending its bylaws to tighten the requirements for filling Board vacancies. For example, a company could provide that a vacancy may be filled:

- Only by the Board; and
- Only for the period remaining in the term of the departing director.

Such requirements impede the ability of a dissident shareholder to replace a departing director with its own nominee.

Shareholder Rights (Poison Pill) Plans

A shareholder rights plan, or *poison pill*, can be a powerful takeover defense that encourages acquirers to negotiate with the Board so the Board can seek to obtain the best value for shareholders in the event of an acquisition. A standard shareholder rights plan results from a Board's declaration of a special dividend of one right per share of common stock. While differences among plans exist, most shareholder rights plans contain the following common principal features:

- If a bidder acquires a set percentage, usually ranging between 10% and 20% of the company's stock (the Board sets the trigger threshold), the rights allow common shareholders, except the bidder, to purchase shares of a new series of common or preferred stock of the company at a discount. This is called a *flip-in* provision.

- If, after a bidder acquires in excess of the trigger threshold, the company merges or sells more than 50% of its assets, the rights allow common shareholders to purchase shares of the acquiring company at a discount. This is called a *flip-over* provision.
- The Board can facilitate a friendly transaction by redeeming the rights at a nominal cost or by waiving the application of the plan to a favored bidder before that bidder crosses the trigger threshold.
- Once an acquiring company crosses the trigger threshold, the Board can exchange each right, except rights held by the bidder, for a specified percentage of the securities issuable on exercise of the rights. Companies should consider exchange provisions because these provisions require the reservation of fewer shares of common stock, do not require cash to exercise, and result in automatic and definite dilution.

A company can adopt a shareholder rights plan through Board action at any time, if sufficient authorized, unissued preferred stock shares or common stock shares are available under the certificate or articles of incorporation for issuance pursuant to the poison pill. In order to implement a preferred stock shareholder rights plan, the certificate or articles of incorporation of the company should ideally authorize *blank check* preferred stock.

Shareholder rights plans are proven and effective tools in defending against takeover attempts and inadequate acquisition offers. However, shareholder rights plans are not designed to, and will not, deter all hostile takeover attempts. Specifically, a shareholder rights plan will not prevent a successful proxy contest for control of a company's Board, nor can it override the fiduciary obligations of the Board to consider a fairly priced, any-and-all cash tender offer for the company's shares. A shareholder rights plan will, however, encourage a potential acquirer to negotiate with the company's Board as an alternative to triggering the rights and thereby diluting the interest of the bidder in the target company and substantially increasing the cost of a takeover to the bidder.

The Delaware Court of Chancery reaffirmed the validity of shareholder rights plans as a permissible defensive measure for Delaware corporations faced with a takeover proposal found to be

inadequate by a target's Board. In *Air Products & Chemicals, Inc. v. Airgas, Inc.*, the Delaware Court of Chancery confirmed that while a Board cannot just say never to a hostile tender offer, the Board can implement defensive measures to prevent consummation of such a tender offer if it is acting in good faith with a reasonable factual basis for its decision.



Practical Tip: Let Time Be Your Friend

The best time to institute many structural defenses, such as a staggered Board, is prior to going public. It is less common, though not unknown, for companies to implement shareholder rights plans immediately prior to their IPOs. Advantages of pre-IPO adoption include:

- A Board can thoughtfully implement the takeover measures well in advance of any immediate threat; and
- A company can avoid the problems and uncertainty that tend to arise when seeking shareholder approval as a public company.

However, there are disadvantages that cause other companies to hold off from pre-IPO adoption:

- Buyers frown on a protection-laden IPO;
- The threat of takeover may seem remote in an optimistic IPO environment; and
- Control or venture capital shareholders are seeking liquidity and may welcome takeover interest.

Recent Developments in Shareholder Rights Plan Implementation

Evolution of Ownership Positions

Companies have recently included language in their shareholder rights plans to account for so called “synthetic” or hedged positions. Similarly, companies are revising the trigger provisions

of their shareholder rights plans to encompass any coordinated behavior among related shareholders. The importance of addressing hedged positions or investors acting in concert is heightened following the Second Circuit's decision in *CSX Corp. v. Children's Investment Fund Management*, when the court rejected the Southern District of New York's holding that a long party to a total-return swap with eight different short counterparties should be required to disclose its beneficial ownership of the shares held by the counterparties as a hedge to the swaps. The revisions to the trigger provisions of shareholder rights plans are seen as a response to the sophisticated and often opaque ownership positions taken by hedge funds and other derivatives traders.

Net Operating Loss Poison Pills

Given the economic downturn beginning in 2008, net operating losses (NOLs) have become significant assets for many companies. Section 382 of the Internal Revenue Code generally limits a company's ability to use its pre-ownership change NOL carryovers to offset taxable income if the company experiences an ownership change. Under Section 382, an *ownership change* occurs if one or more 5% shareholders of the company increase their ownership by more than 50 percentage points in the aggregate over the lowest percentage of the company's stock owned by those shareholders at any time during the preceding three-year period. In the aftermath of the economic downturn, companies with significant NOLs have increasingly taken measures to protect their NOL assets by adopting *NOL poison pills*. A NOL poison pill operates similarly to a traditional shareholder rights plan, but with lower triggering thresholds. A poison pill is designed to dilute a buyer's stake in a company if the acquirer's ownership stake rises above a certain percentage, typically between 10%-20%. A NOL poison pill is intended to protect a company's valuable NOLs that can be used to offset future taxable income and is generally triggered if a party acquires greater than 4.99% of the value of the company's shares.

The adoption and implementation of a NOL poison pill has been upheld in Delaware. The Delaware Supreme Court affirmed the Delaware Court of Chancery's decision in *Selectica, Inc. v. Versata Enterprises, Inc.* where Selectica sought a declaratory judgment to uphold its decision to reduce its standard poison pill trigger from 15% to 4.99% in order to protect its NOL. Versata had

proposed to acquire some or all of Selectica's business, and was subsequently rejected in its efforts. Versata subsequently began acquiring Selectica stock until it acquired over 5% of Selectica's outstanding stock. Selectica's Board met, after consulting with its advisors, and decided to amend the company's existing shareholder rights plan, which was set to trigger at 15%, to trigger at 4.99%. Selectica allowed existing 5% or more shareholders to acquire up to an additional 0.5% without triggering the poison pill. Versata purchased additional shares of Selectica's stock in excess of the permitted 0.5%. Selectica's Board declined to grant Versata the exemption and exchanged the rights for new common stock, thereby triggering the poison pill and reducing Versata's ownership by approximately half.

The Delaware Court of Chancery held that the Selectica Board acted reasonably in its determination that the NOL represented a significant business asset worth protecting. Accordingly, the court held that the implementation of a NOL poison pill by reducing the trigger ownership percentage constituted an appropriate defensive response to the perceived and actual threats.

State Statutory Antitakeover Provisions

Delaware, the most common domicile of public companies, like virtually every other state, has adopted an antitakeover statute. State antitakeover statutes are generally based on a control share, business combination or fair price model.

- *Control Share Statutes* prohibit an acquirer from voting shares of a target company's stock after crossing specified ownership percentage thresholds. The acquirer may proceed if it obtains the approval of the target company's shareholders to cross each ownership threshold.
- *Business Combination Statutes* prohibit the target company from entering into specified significant business transactions – mergers, sales of assets and other change-of-control transactions – with an acquirer for a three- to five-year period after the acquirer crosses a specified ownership percentage threshold. Under this regime, an acquirer may proceed if it obtains the approval of the target company's Board prior to acquiring its ownership interest.

- *Fair Price Statutes* protect shareholders from the coercive effects of two-tier tender offers by requiring approval of a second-stage merger by a supermajority shareholder vote. Alternatives to the shareholder vote include having a disinterested Board approve the transaction or ensuring that second-stage merger consideration equals the consideration paid in the first-stage tender offer, both in terms of amount and type of consideration.

Delaware Section 203: A Business Combination Statute

Section 203 of the Delaware General Corporation Law is a business combination statute. Section 203 limits any investor that acquires 15% or more of a company's voting stock (thereby becoming an *interested shareholder*) from engaging in certain business combinations with the issuer for a period of three years following the date on which the investor became an interested shareholder, unless:

- The company's Board has approved, before the acquirer becomes an interested shareholder, either the business combination or the transaction that resulted in the investor's becoming an interested shareholder;
- Upon consummation of the transaction that made the investor an interested shareholder, the interested shareholder owned at least 85% of the voting stock outstanding at the time the interested shareholder began the transaction that resulted in its becoming an interested shareholder (excluding shares owned by persons who are both directors and officers and shares held in employee stock plans that do not provide plan participants with the opportunity to tender shares on a confidential basis); or
- The business combination is approved by the Board and authorized by the affirmative vote of at least 66-2/3% of the outstanding voting stock not owned by the interested shareholder (at a meeting, and not by written consent).

Section 203 defines a business combination broadly to include:

- Any merger or sale, or other disposition of 10% or more of the assets of a company, with or to an interested shareholder;

- Transactions resulting in the issuance or transfer to the interested shareholder of any stock of the company or its subsidiaries;
- Certain transactions that would result in increasing the proportionate share of the stock of a company or its subsidiaries owned by the interested shareholder; and
- Receipt by the interested shareholder of the benefit (except proportionately as a shareholder) of any loans, advances, guarantees, pledges or other financial benefits.

A Delaware company may opt out of Section 203:

- If the company's original certificate of incorporation contains a provision expressly electing not to be governed by Section 203; or
- If the company's shareholders approve an amendment to its certificate of incorporation or bylaws expressly electing not to be governed by Section 203. This amendment must be approved by a majority of the outstanding shares entitled to vote, and it is not effective until 12 months after adoption. An opt-out amendment will not apply to any business combination with an investor that became an interested shareholder prior to the adoption of an opt-out amendment.

Practical Tip:

Waive the Statute? Yes – But Use Care



In a friendly acquisition, a buyer may request that a company's Board waive the application of any state antitakeover statutes that could prevent or delay the transaction. To satisfy their duty of care, directors should take the following actions before granting a waiver:

- Ask management and legal counsel to brief the Board on the application of the antitakeover statute; and
- Ask about and understand all possible impacts of the waiver requested by the buyer.

Authorized Common and Blank Check Preferred Stock

A company should maintain sufficient amounts of common stock and blank check preferred stock in order to retain maximum flexibility in employing corporate structural defenses.

Common Stock

As a general matter, a public company should ensure that it always has an adequate number of authorized shares of common stock, taking into account both outstanding shares and the number of shares issuable upon conversion or exercise of outstanding or anticipated preferred stock, stock options and warrants. The company should maintain sufficient authorized, but unissued and unreserved, shares of common stock for:

- Current and future stock incentive plans;
- Potential stock splits and dividends;
- Strategic acquisitions; and
- Equity financings.

Preferred Stock

The company's certificate or articles of incorporation may authorize *blank check* preferred stock – a specified number of shares of authorized but undesignated preferred stock. Authorizing blank check preferred stock gives the Board the authority, without having to seek prior shareholder approval, to designate one or more series of preferred stock out of the undesignated shares and to establish the rights, preferences and privileges of each series.

Taken together, blank check preferred stock and a reserve of authorized but unissued shares of common stock provide flexibility to target companies in the following ways:

- The shares may be sold to a friendly party;
- The shares may be used as consideration for a defensive reorganization or acquisition;
- The shares may be used to grant a friendly party a lock-up option to acquire shares; or
- The shares may be used to implement a shareholder rights plan.



Trap for the Unwary: The NYSE or Nasdaq May Require Shareholder Approval of 20% Stock Issuances

Even if a company has authorized sufficient common stock or preferred stock, NYSE or Nasdaq rules may require shareholder approval of certain large stock issuances. For example, Nasdaq requires shareholder approval of the issuance of common stock (or securities convertible into common stock) equal to 20% of the outstanding common stock or 20% of the voting power prior to the issuance for less than book or market value of the stock. (We discuss this and the NYSE's similar requirement in detail in Chapters 8 and 9.)

Limitations on Shareholders' Meetings and Voting Requirements

Limitations on shareholders' meetings and other shareholder action can slow the efforts of an acquirer to appeal directly to shareholders without negotiating with a target company's Board. For example, if shareholders can act only at annual meetings, an unfriendly third party would be unable to acquire control of the company by soliciting written consents to remove directors and elect a new Board.

Limitations on the Right to Call Special Shareholders' Meetings

A company may defend against coercive takeover attempts by appropriately limiting the power of shareholders to call special shareholders' meetings. Delaware law provides that only the Board and persons authorized in the company's certificate of incorporation or bylaws may call a special meeting of shareholders. Thus, absent authorizing language in a company's certificate of incorporation or bylaws to the contrary, a Delaware company may entirely eliminate the right of shareholders to call a special shareholders' meeting. In other states, however, a certain percentage of shareholders have a statutory right to call a special shareholders' meeting. A company incorporated outside Delaware may still increase the default percentage of shareholders required for shareholders' meetings and, in some cases, entirely eliminate this right.

Limiting the right of shareholders to call special meetings can ensure additional time to negotiate by preventing a would-be acquirer from electing a class of directors or gaining control of the Board until the company's next annual shareholders' meeting.

Advance Notice Bylaw Provisions

Advance notice bylaw provisions provide that shareholders seeking to bring business before, or to nominate directors for election at, any shareholders' meeting must provide written notice of such action within a specified number of days (usually 60 to 90) in advance of the meeting. Since only business contained in the meeting notice may be conducted at special shareholders' meetings, these bylaw provisions can delay the efforts of coercive acquirers and prevent surprises at shareholders' meetings.

Delaware courts have upheld advance notice bylaw provisions as appropriate mechanisms to give shareholders an opportunity to evaluate shareholder proposals and to give the Board adequate time to make informed recommendations. Advance notice bylaw provisions may not unduly restrict shareholder rights. Companies should also review and clarify advance notice bylaw provisions to ensure that these provisions are clearly written, as courts may narrowly construe ambiguous advance notice provisions in favor of activist shareholders.

Practical Tip: It May Be Time to Revise Your Advance Notice Provision



In *JANA Master Fund, Ltd. v. CNET Networks, Inc.* and *Levitt Corp. v. Office Depot, Inc.*, the Delaware Court of Chancery narrowly interpreted advance notice bylaw provisions in favor of shareholder activists. In each case, the court permitted shareholders to nominate directors without complying with advance notice provisions in the companies' bylaws, contrary to the apparent intent of the companies. These Court of Chancery decisions highlight the need for public companies to carefully review and, if necessary, clarify and expand the advance notice provisions of their bylaws to eliminate ambiguities and establish procedures shareholders must follow



Practical Tip:
**It May Be Time to Revise Your Advance
Notice Provision (Cont'd)**

and information they must supply. Although these cases were decided by the Delaware Court of Chancery, courts in other jurisdictions may be influenced by these decisions in interpreting advance notice provisions.

Consider working with your counsel to determine if these or other recommendations may be applicable to your advance notice provisions:

- Make clear that the advance notice process is separate from and in addition to the requirements under Rule 14a-8 under the 1934 Act (governing shareholder proposals submitted for inclusion in the company's proxy materials). (We discuss Rule 14a-8 shareholder proposals in Chapter 5.)
- Make clear that the process for director nominations is separate from the process for other business to be brought by shareholders.
- Clarify that your company's notice of meeting applies only to the election of your company's slate of directors.
- Set the advance notice deadline with reference to the date of the previous year's annual meeting, rather than the date proxy materials were released for the previous year's meeting.
- Establish a "no earlier than" date for shareholder-proposed nominations and other business.
- Coordinate the advance notice provision with the e-proxy deadline and other timing requirements. (We discuss e-proxy rules in Chapter 5.)
- Expand required disclosure of ownership information and shareholder interests.

Elimination of Shareholder Action by Written Consent

Under Delaware law, unless otherwise provided in a company's certificate of incorporation, any action required or permitted to be taken by shareholders may be taken by written consent, without a meeting or shareholder vote. A valid written consent sets forth the action to be taken and is signed by the holders of outstanding stock having the requisite number of votes that would be necessary to authorize the action at a shareholders' meeting. The certificate of incorporation may prohibit shareholder action by written consent. Such a prohibition has the effect of confining shareholder discussion of proposed actions only to shareholders' meetings. As a result, the holder or holders of a majority of the voting stock of a company may not take preemptive, unilateral action by written consent, and may only act within the framework of a shareholders' meeting.

Supermajority Vote on Merger or Sale of Assets

Delaware law requires shareholder approval for any merger or sale of substantially all the assets of a company. A Delaware company's certificate of incorporation or bylaws may include a supermajority provision requiring more than a simple majority (generally companies choose a percentage between 60% and 80%). A typical provision requires the affirmative vote of 66-2/3% of the voting shares for any merger or sale of substantially all the company's assets if, at the time of the vote, the company has a controlling shareholder (i.e., a shareholder holding a substantial block of stock, such as 10%). A supermajority provision often requires a potential acquirer to obtain a greater number of shares in order to complete the acquisition.

In deciding whether to adopt a supermajority requirement for a merger or sale of substantially all a company's assets, it is important for a Board to consider:

- Too high a standard can allow minority holders to block favorable acquisitions and other transactions; and
- If a company is listed on an exchange, it may be subject to additional restrictions or listing requirements.



Practical Tip: Create an Escape From Supermajority Requirements

Supermajority vote provisions should include an *out* – an exception calling off the supermajority vote requirement under specified circumstances. For example, the bylaws could provide for either (a) a supermajority vote or (b) the simple majority required by statute if the transaction is approved by a majority of directors serving before the controlling shareholder acquired its controlling stake in the company.

Another common exception comes into play in two-tier tender offers. A company's bylaws may provide for the elimination of the supermajority vote requirement in a two-tier tender offer if the acquirer consents to purchase, at a fair price determined by a specified calculation, the shares remaining after the initial stage of the tender offer. This so-called *fair price* provision is designed to discourage only coercive, front-end loaded, two-tier tender offers. Two-tier tender offers, common in the 1970s and 1980s, occur much less frequently now due in part to the implementation of fair price provisions.

Supermajority Vote on Amendments to Certificate of Incorporation

The default rule under Delaware law provides that a simple majority of a company's voting securities must approve any amendments to a company's certificate of incorporation. A company's certificate of incorporation or bylaws, however, may include so-called *lock-in* provisions that require supermajority voting on specified amendments to a company's charter documents. Lock-in provisions force a hostile acquirer to control a greater number of shares in order to eliminate a company's corporate structural defense provisions by amending the certificate of incorporation or bylaws. However, supermajority voting requirements reduce a company's flexibility to make other desirable changes to its certificate of incorporation. As a result, a company may choose to retain a majority approval requirement for amendments to most of the provisions of its certificate of incorporation, and to require a

supermajority approval only for amendments to those particular provisions that provide takeover protection, such as provisions dealing with:

- A classified Board;
- Removal of a director for cause;
- The right of shareholders to call special meetings; and
- Supermajority voting provisions for business combinations.

A company may also retain flexibility by providing that the supermajority approval is not required if the amendment is approved by a majority of directors serving before a controlling shareholder acquired its controlling stake in the company.

Trap for the Unwary: Marketing and Disclosure Impact



Every time a public company solicits shareholder approval of amendments to its certificate or articles of incorporation (for example, to increase the authorized number of shares), it must describe its corporate structural defense provisions in a proxy statement for the shareholders' meeting. The existence of extremely formidable structural defense measures may suggest to shareholders and prospective investors that the company adamantly opposes a change of control. Institutional investors may prefer the short-term returns engendered by hostile takeovers, and are likely to vote against many corporate structural defense provisions. For this reason, public companies should:

- Avoid adopting every possible measure of protection;
- Choose only those defenses best designed to maximize shareholder value; and
- Tailor protections to the company's situation and to its perceived vulnerability to takeover attempts.

Other Actions: Change-of-Control or Golden Parachute Agreements

Change-of-control, or *golden parachute*, agreements are employee benefits with protective overtones. These arrangements, which can be stand-alone agreements or severance provisions included in employment agreements, provide key executives some economic certainty by triggering a cash payment (or the automatic vesting of stock options, restricted stock or other noncash benefits) on the occurrence of a change-of-control event, including a merger, sale of assets or stock, or a change of the constituency of the Board. *Single trigger* agreements result in a severance payment becoming due on the occurrence of a change of control alone. The more common *double trigger* agreements result in a severance payment only if the triggering event is coupled with a significant change in job status or compensation (for example, termination of employment or decrease in salary or responsibilities). Change-of-control agreements may enable the Board to retain key management during and after a takeover attempt because acquirers may not be willing to have the company incur the cost of a severance payment or the loss of human capital accompanied by the dismissal of key management.

Best Protections

Corporate structural defenses are not absolute deterrents. Instead, defenses are designed to give directors and management time to consider the merits of an offer as well as leverage to negotiate that offer and counteract the coercive tactics that sometimes characterize takeover contests.

Some of the strongest protections against an unfriendly takeover are not special provisions in a company's charter documents, but are, in this order:

- A significant block of stock held by friendly shareholders;
- A high stock price and price/earnings ratio;
- Strong state antitakeover statutes (protections under Delaware law are among the best available); and
- A shareholder rights plan.

Chapter 11

Follow-On Offerings and Shelf Registrations

Each offering of securities to the public requires the issuer to register those securities with a 1933 Act registration statement unless an exemption from registration is available. Shelf registrations can ease the burden associated with the registration process by allowing one registration statement to register a variety of securities in advance of one or more transactions.

The SEC has adopted a variety of 1933 Act registration forms that require differing levels of disclosure depending on the type of transaction to be registered and the 1934 Act reporting history of the registrant. The most commonly used forms are:

- *Form S-1* – long form typically used for IPOs and sometimes for other sales of securities.
- *Form S-3* – short form typically used for follow-on financing transactions and public resales of a company's securities by selling shareholders, available only if Form S-3's eligibility requirements are met.
- *Form S-4* – used to register securities to be issued in merger and acquisition transactions that involve an offer and sale of securities to shareholders of a target company and for exchange offers.
- *Form S-8* – used to register securities to be issued to employees, directors and certain types of consultants under employee benefit plans, including stock option plans.

We discuss each of these forms in more detail in this chapter.

Sales under a registration statement should only be made after the registration statement becomes effective. Appropriately checked

registration statements on Form S-3 filed by Well-Known Seasoned Issuers (WKSIs) and all registration statements on Form S-8 become automatically effective when they are filed. (We discuss WKSIs later in this chapter.) In most other cases, the SEC has the opportunity to review and comment on a registration statement before effectiveness. In these cases, the SEC takes administrative action, upon a company's written request, to declare a registration statement effective. This usually happens after the SEC Staff is satisfied that the registration statement, as may be amended, adequately addresses its comments (if any). The SEC will post a notice of effectiveness on the company's EDGAR filings index page that indicates the date and time of the declaration of effectiveness.

Primary Offerings and Secondary Offerings – What's the Difference?

A company typically first gains access to the public capital markets through the IPO process. Following its IPO, a company may continue to raise capital through additional public offerings of debt or equity securities. These additional public offerings are sometimes referred to as *follow-on* offerings, as they follow the IPO. Follow-on offerings made directly by a company, as well as IPOs, are referred to as *primary offerings* to distinguish them from registered offerings of securities on behalf of selling shareholders, which are referred to as *secondary offerings*.

In a secondary offering, selling shareholders, not the registrant, receive the proceeds from the offering. These offerings provide immediate liquidity to the selling shareholders. For example, shareholders may hold restricted shares purchased from the company in a private financing transaction, which cannot be easily or quickly resold except through a registered public offering. In connection with a private financing transaction, a company may agree to register securities for resale and enter into a "registration rights agreement" for the benefit of the security holders. Another example of a secondary offering is when a shareholder holding a large number of shares chooses an underwritten public secondary offering as an orderly and efficient means of liquidating its position.

Shelf Registrations

A shelf registration allows a company to register the offer and sale of securities on a delayed basis (for future use) or on a continuous basis. Often public companies register securities for offer and sale to

the public at an undetermined future date to be able to take advantage of favorable market conditions when they occur. Public companies may also use shelf registrations to permit shareholders to sell otherwise restricted securities (for example, securities issued in a private placement) in the public market over a period of time.

Common Types of Shelf Registrations

Three common types of shelf registrations are the universal shelf, the resale shelf and the acquisition shelf.

Universal Shelf. A universal shelf is a registration statement on Form S-3 that registers a variety of securities that a company may wish to sell in the future. Form S-1 is not available for this kind of registration. A universal shelf registration statement will typically include some combination of common stock, preferred stock, convertible and nonconvertible debt securities and warrants to purchase stock. In this type of registration statement, a company specifies the aggregate dollar amount of all the securities it intends to offer, rather than specifying the dollar amount of each type of debt security or the number of each type of equity security it is registering. (As we discuss later in this chapter, a WSKI may register securities by specific types or classes on Form S-3 without indicating any dollar amount or number of securities.)

A universal shelf registration statement includes a *base prospectus*, which often includes only a section listing the documents incorporated by reference, a brief overview of the company, an outline of the plan of distribution, a short description of the intended use of the proceeds from a sale of the securities and, generally, a high-level description of each type of security that is being registered. The base prospectus does not contain pricing information regarding any particular transaction. This additional information is included in a prospectus supplement, which is filed with the SEC when there is a sale of securities (a takedown). For instance, a prospectus supplement filed in connection with a takedown of debt securities will disclose the aggregate principal amount offered, the public offering price, any discounts and commissions, a detailed description of the terms of the securities (including the rate at which interest will accrue, interest payment dates and the maturity date) and a more-detailed description of the plan of distribution.

In many cases, underwriters will use a preliminary prospectus supplement that does not include pricing information, but does include more specificity about a particular transaction for marketing an offering to potential investors. Once an offering is priced, a *free writing prospectus* – usually a one-page document providing only the previously omitted pricing information – is usually prepared and filed with the SEC. The underwriters then use this free writing prospectus to confirm sales. An issuer then prepares and files a final prospectus supplement that includes the pricing information provided in the free writing prospectus and any other final changes to the prospectus supplement.

Resale Shelf. Companies typically use a resale shelf registration statement on Form S-3 to register the resale to the public of securities held by an affiliate of the issuer or securities that were issued in a private placement. The prospectus of a resale shelf registration statement on Form S-3 tends to be very short. It usually includes a section listing the company's SEC filings and incorporates them by reference, a section on risk factors, a list of the selling shareholders (including the name, address and number of securities a holder plans to sell) and descriptions of their related transactions with the company and a section that outlines the manner in which the securities are to be distributed.

If a company is not eligible to use Form S-3, the company could file a resale shelf registration statement using Form S-1. Keeping a resale shelf registration statement on Form S-1 updated is, however, much more time-consuming and expensive than with Form S-3. This is because Form S-1 does not allow forward incorporation by reference of a company's 1934 Act reports. As a result, a company would have to continually update a resale registration statement on Form S-1 by filing prospectus supplements and post-effective amendments to reflect material developments and updated financial information.

Practical Tip:
**Your Company Has Heightened Disclosure
Obligations When Using a Resale Shelf**



Whenever your company has an effective resale shelf registration statement, you have an obligation to disclose material information and to regularly update the information disclosed in prior filings. Because sales are being made pursuant to the resale shelf over an extended period of time, your company (and your officers and directors) may be liable to purchasers of the shares under Rule 10b-5 under the 1934 Act if the information contained in the resale shelf prospectus contains disclosure that is inaccurate or misleading, or omits material information. Accordingly, during the period in which the resale shelf registration statement is effective, ensure that the right person at the company is continually monitoring and updating the information included or incorporated in the prospectus to keep it accurate and complete. As a prospectus related to a shelf registration on Form S-3 is automatically updated through incorporation by reference of subsequently filed 1934 Act reports, officers should maintain a heightened awareness of any nonpublic developments and, where material, disclose the developments on a filed Form 8-K.

Agreements to file resale shelf registration statements can form an important part of a venture fund's exit strategy. When a venture fund invests in a privately held company, the company often agrees at the time of the investment to file for the venture fund one or more shelf registration statements on Form S-3 after the company has completed its IPO. This arrangement provides liquidity for the venture fund's investment.

Companies also use resale shelf registrations after issuing securities in an acquisition transaction. For instance, when acquiring a privately held company, a public company may issue restricted shares to the shareholders of the target company. Often, the shareholders of the target company will require the acquirer to register the shares they received in the acquisition by filing a resale shelf registration statement on Form S-3 soon after the closing of the acquisition.

Companies may also file resale shelf registration statements in connection with PIPE (Private Investment in Public Equity) transactions. In a PIPE transaction, a public company typically agrees to sell shares of its common stock to institutional investors in a private placement, usually at a significant discount to the market price, with a resale shelf registration statement on Form S-1 or S-3 filed shortly after closing. The benefit to the company of a PIPE transaction is that the company is able to obtain the proceeds of the sale much faster than it otherwise would if it were to launch a registered public offering that is subject to the SEC review and comment process.

Companies typically agree to keep their resale shelf registration statement *effective* (meaning that the prospectus will be kept up to date and shareholders will be allowed to sell under the registration statement) for a certain period of time, usually until the time at which shares become freely transferable under Rule 144 under the 1933 Act. (We discuss Rule 144 in Chapter 4.) This allows holders of restricted securities to have some control over the timing of their resales. A company would then file an amendment to the registration statement to deregister any remaining unsold securities from registration, which terminates the effectiveness of that registration statement.

Acquisition Shelf. An acquisition shelf provides for the issuance of equity securities as consideration in future acquisitions. An acquisition shelf registration statement is usually filed on Form S-4 and cannot be filed on Form S-3. (We discuss acquisition shelf registration statements in greater detail later in this chapter.)

Registration Statements on Form S-1

A company usually uses Form S-1 just once – for its IPO. Companies that are not eligible to use Form S-3, as described below, also use Form S-1 to register follow-on or secondary offerings. For example, a company that conducts an offering less than a year after its IPO will use Form S-1, due to its limited 1934 Act reporting history.

Form S-1 is the most comprehensive of the registration statements. The Form S-1 prospectus requires complete information regarding the registrant and the transaction. If the company has filed

all required 1934 Act reports and has filed at least one annual report on Form 10-K, it may be eligible to incorporate the previously filed 1934 Act reports by reference. Form S-1 does not, however, permit *forward-looking* incorporation by reference of 1934 Act reports, that is, those filed after the effective date of the registration statement.

Registration Statements on Form S-3

Use of Form S-3 is more cost-effective and efficient than use of Form S-1 to register follow-on and secondary offerings. Form S-3 allows the issuer to update disclosure through incorporation by reference into the prospectus and registration statement of the issuer's subsequently filed 1934 Act reports. This *evergreen* feature means that a company generally will not need to file any post-effective amendments to the registration statement. Post-effective amendments, for public companies other than WKSIs, are potentially subject to SEC review – a time-consuming and potentially expensive proposition.

Companies often use Form S-3 registration statements for shelf registrations, as we describe in more detail earlier in this chapter. A key advantage of a shelf registration is that once the Form S-3 registration statement becomes effective, any takedown from the shelf typically does not require SEC approval. This expedites issuance of securities and reduces overall costs. A company can use its shelf registration statement on Form S-3 for follow-on offerings for three years. After the three years, a company can roll over the SEC fees related to any unsold securities to a new shelf registration statement.

Eligibility Restrictions on Use of Form S-3

In order to be eligible to use the very convenient Form S-3 registration statement, companies must meet both *registrant* and *transaction* eligibility requirements.

Registrant Requirements. To qualify for use of Form S-3, a company must have been required to file 1934 Act reports for at least 12 months. Additionally, the company must have timely filed 1934 Act reports and information that were required to be filed during the 12 months and any portion of a month preceding the date of the registration statement. Also, since the end of the fiscal

year covered by its most recent annual report on Form 10-K, the company must not have failed to pay any dividend or sinking fund installment on preferred stock, or defaulted on any material debt or long-term lease.

Transaction Requirements. Registrants that meet the registrant requirements may use Form S-3 only to register offerings that fall within one or more of Form S-3's permitted transaction categories.

Follow-on Offerings by Issuers With a Minimum Public Float. A qualified registrant that has a public float of at least \$75 million as of a date within 60 days of the Form S-3 filing date may use Form S-3 to register *any* primary or secondary offering of debt or equity securities for cash. The term *public float* refers to the aggregate market value of the voting and nonvoting common equity held by non-affiliates of the company. This permitted transaction category is significant because it allows a registrant to conduct a primary offering of common stock without limitation on the amount offered.

Transactions That Do Not Require a Minimum Public Float. A qualified registrant that does not have a public float of at least \$75 million may nonetheless use Form S-3 to register certain qualified transactions, including the following:

- Secondary offerings, provided the class of securities to be offered is listed on a national securities exchange (such as the NYSE or Nasdaq);
- Primary offerings of nonconvertible securities, other than common equity, if the company is a wholly owned subsidiary of a WKSI or if the company as of a date within 60 days of filing the registration statement has:
 - Issued at least \$1 billion in aggregate principal amount of nonconvertible securities (other than common equity) in registered primary offerings for cash in the past three years; or
 - Outstanding at least \$750 million in aggregate principal amount of nonconvertible securities (other than common equity), which were issued in registered primary offerings for cash;
- Securities to be offered upon the exercise of outstanding rights under a dividend or interest reinvestment plan, or

upon the conversion or exercise of outstanding convertible securities, including options and warrants; and

- Primary offerings of securities for cash by a company (not a shell company) listed on a national securities exchange so long as the aggregate value sold during any 12-month period (including the potential offering) does not exceed one-third of that company's public float.

**Breaking News:
Credit-Ratings Criteria Eliminated From
Form S-3 Eligibility**



In July 2011, the SEC, as required by Section 939A of the Dodd-Frank Act, approved amendments to the eligible transaction requirements for Form S-3, which eliminated use of credit-ratings criteria for potentially qualifying for use of Form S-3. As a result of these amendments, some companies may no longer be eligible to use Form S-3. To address these new restrictions, the SEC adopted a three-year grandfathering provision regarding nonconvertible investment grade securities. If your company has been relying on qualifying nonconvertible investment grade securities for Form S-3 eligibility, consult with your counsel to determine whether your company is qualified to take advantage of this grandfathering provision.

Unique Flexibility for WKSIs

In 2005, the registration, communications and offering processes under the 1933 Act were significantly modified, providing companies with varying degrees of increased flexibility in conducting securities offerings. This flexibility depends on membership in one of four issuer categories based on a company's reporting history under the 1934 Act and its equity market capitalization or fixed income issuance history. One of these four issuer categories is the WKSI category. Companies meeting the WKSI criteria can access the markets more quickly and with less expense than non-qualifying peers.

To qualify as a WKSI, a company generally must:

- Meet the registrant eligibility requirements of Form S-3, including having timely filed all required 1934 Act reports and information during the preceding 12 months;
- Within 60 days of the WKSI-determination date, have at least either \$700 million of public float outstanding or issued in aggregate \$1 billion of nonconvertible securities, other than common equity, in registered primary offerings for cash, during the prior three years; and
- Not be an *ineligible issuer* – generally, companies that are not current in filing 1934 Act reports, blank check companies, shell companies, penny stock issuers, some limited partnerships, and companies that have filed for bankruptcy, have been the subject of refusal or stop orders, or have violated the antifraud provisions of the federal securities laws during the previous three years.

WSKIs have additional flexibility in using shelf registration statements. WSKIs may file shelf registration statements on Form S-3 that are automatically effective upon filing. These shelf registration statements are not subject to review and comment by the SEC prior to their use. This means that an offering under one of these registration statements can begin immediately after it (along with an appropriate prospectus supplement) is filed with the SEC. In contrast to other Form S-3 filers, a WKSI does not have to include any of the following information in a shelf registration statement on Form S-3:

- Amount of securities to be offered;
- Allocation of the registered securities between primary and secondary shares;
- Description of the securities (other than the name or class of securities); or
- Outline of the plan of distribution.

A WKSI can essentially make unlimited sales off its shelf registration statement and provide the required information omitted from the prospectus that is filed on Form S-3 in a prospectus supplement used at the time of the offering. If the WKSI chooses, it can file the required disclosure at the time of the offering

in a 1934 Act report, such as a current report on Form 8-K, which would be automatically incorporated by reference into the registration statement. A WKSI can also pay SEC registration fees on a “pay-as-you-go” basis, rather than at the time of initial filing.

A WKSI’s ability to use Form S-3 as an automatically effective shelf registration statement depends on how the company qualifies as a WKSI:

- *\$700 Million Public Float.* A company that qualifies as a WKSI based on public float (\$700 million or more) is eligible to conduct an offering for any kind of security on an automatically effective shelf registration statement using Form S-3.
- *\$1 Billion of Nonconvertible Securities.* A company that qualifies as a WKSI based on the aggregate value of issuances of its nonconvertible securities (other than common equity) in registered offerings for cash during the three previous years (\$1 billion or more) may only use Form S-3 as an automatically effective shelf registration statement to register nonconvertible securities (other than common equity). If, however, the value of the company’s common equity held by non-affiliates is at least \$75 million, it may also register any other securities using Form S-3 as an automatically effective shelf registration statement.

A company’s status as a WKSI is determined at the date of the initial filing of the registration statement and at the time of the filing of any amendment to the registration statement, as well as annually in connection with its Form 10-K filing.

Use of Form S-3 by Small Public Companies

In 2008, the SEC relaxed Form S-3 eligibility for public companies whose public float is less than \$75 million in an effort to facilitate faster and easier capital market access. These amendments permit use of Form S-3 for offerings by qualifying smaller public companies previously ineligible for Form S-3 use due to public float requirements.

Now, a smaller public company may offer and sell a limited amount of securities pursuant to Form S-3 in primary offerings for

cash. Specifically, the amount of securities offered using Form S-3 may not exceed one-third of the company's public float during any 12-month period. To determine whether an offering is permissible under Form S-3's one-third-public-float limitation, a company must calculate the one-third limit based on the value of its public float as of a date within 60 days of the intended sale. A small public company discloses in each Form S-3 prospectus an updated calculation of its public float and the amount of securities offered, including those in the intended sale, in the 12-month period ending on the date of the prospectus.

Only small public companies that have a class of common equity securities listed on a national securities exchange may take advantage of these relaxed Form S-3 eligibility requirements. Small companies whose equity securities are only traded over-the-counter (e.g., on the U.S. OTC Markets) are not eligible. Any company that is a shell company at the time of the offering, or that was a shell company at any time in the previous 12 months, is not eligible to benefit from these relaxed Form S-3 eligibility requirements.

The term *shell company* means a company, other than an asset-backed issuer, that has no or nominal operations and any one of the following applies:

- The company has no or nominal assets;
- The company's assets consist solely of cash and cash equivalents; or
- The company's assets consist of any amount of cash and cash equivalents and nominal other assets.

Form S-4: The M&A Registration Statement

Companies can use Form S-4 to register securities to be issued in merger and acquisition transactions that involve an offer and sale of securities to the shareholders of the target company. Generally, an offer and sale of securities is deemed to be involved when the target company's shareholders are asked to vote on, or consent to, a plan or agreement for a reclassification, merger, consolidation or transfer of assets. Companies can also register securities on Form S-4 that they plan to issue in exchange for their outstanding securities or outstanding securities of another entity.

Form S-4 is unique in that it is a single document that satisfies both the 1933 Act registration requirements and the 1934 Act proxy solicitation and information requirements. The core disclosure document in a Form S-4 serves as the proxy or information statement of the target company for purposes of soliciting shareholder approval of the transaction. It also serves as the prospectus of the acquiring company for purposes of offering its securities in connection with the transaction. Once the acquiring company's Form S-4 is declared effective by the SEC, the target company can file the same document as its proxy materials in definitive form as a Schedule 14A.

Unless a company uses Form S-4 as an acquisition shelf (we discuss this later in this chapter), this registration statement requires extensive disclosure of the terms of the transaction, including discussion about the background and reasons for the transaction and any fairness opinions provided by financial advisors, as well as a comparison of the rights of shareholders of the two companies.

Practical Tip:
"Dear Diary..."



The "Background of Merger" section is the heart of the disclosure of any merger proposal a company submits to its shareholders. During your negotiations, designate a team member to keep a brief but accurate timeline of critical dates of meetings, due diligence requests, draft documents, telephone calls and other interactions between the target company and the potential acquirer. This timeline usually provides the outline for the "Background of Merger" section.

Information about the company filing the Form S-4 and information about any acquisition target company may be incorporated by reference in certain cases, depending on whether (and on what basis) the companies would be eligible to use Form S-3. A Form S-4 that incorporates by reference must be sent to shareholders at least 20 business days prior to the date of the shareholders' meeting or, if no shareholder vote is required, 20 business days prior to the date of the closing.

Shareholders of the acquired company who receive securities in a transaction registered on a Form S-4 can generally resell their securities immediately after the closing of the transaction. Generally, affiliates of the target company in a business combination transaction will not have resale limitations on their shares under business combination rules. However, significant target company shareholders, who become affiliates of the acquiring company, will have to sell their acquiring company securities under Rule 144. (We discuss Rule 144 in Chapter 4.)

The Acquisition Shelf

One of the major motivations for a rapidly expanding private business to become a public company is to be able to use its stock as currency for acquisitions. The Form S-4 acquisition shelf registration statement is a flexible corporate finance vehicle designed for a series of stock-for-stock acquisitions of privately held target companies by a public company. An acquisition shelf is particularly useful at times when the IPO window is closed to private companies. At those times, stock-for-stock acquisitions by public purchasers represent an attractive exit to shareholders of private target companies who have discovered that a public offering will not provide them an attractive near-term liquidity opportunity.

The closer a purchaser's shares are to cash equivalents (for example, freely tradable shares of a public company that has a large public float and a high trading volume), the higher the value the target company's shareholders will typically attribute to the shares. By contrast, shares that an acquiring company issues in a private placement without registration rights may be valued at a significant discount below the acquiring company's normal public trading price. The three methods to place freely transferable shares into the hands of a private target company's shareholders are:

- A stand-alone registration on Form S-4;
- A private placement, followed by a resale shelf on Form S-3 that registers the sale of shares by selling shareholders; and
- An acquisition shelf.

The SEC first recognized the acquisition shelf in a series of no-action letters (Service Corp. (1985) and later letters). In these, the

SEC authorized the use of Form S-4 to register stock-for-stock acquisitions of private companies that could otherwise be effected under a private placement exemption from registration. Under this SEC authorization, where an acquisition could have been effected pursuant to an exemption from registration, the acquiring company does not need to file a transaction-specific post-effective amendment (or prospectus supplement) to the shelf registration statement on Form S-4 in order to effect the acquisition, even where the acquisition is “material” to the acquiring company.

Prior to initiating discussions with a potential target company’s shareholders, the acquiring company files a Form S-4 shelf registration statement with the SEC. The registration statement will not describe a particular transaction, but will be available for any of a broad range of private company acquisitions. These acquisitions may be effected by merger, consolidation, acquisition of assets or share-for-share exchange. The amount of shares that may be registered on an acquisition shelf may not exceed the amount that the company reasonably expects to use for acquisition transactions in the two years following the filing of the registration statement.

If an acquisition is material to the acquiring company, the Form S-4 will need to be updated after the acquisition before the company can use the Form S-4 for a subsequent acquisition. This may require the filing of a post-effective amendment. Companies that are eligible to use Form S-3, however, should be able to rely on incorporation by reference of 1934 Act reports into the acquisition shelf (including a Form 8-K disclosing a material acquisition) for this purpose.

Practical Tip:
An Acquisition Shelf Checklist



To use an acquisition shelf, confirm that your company fits the following profile:

- Eligible to incorporate by reference 1934 Act reports into the Form S-4;
- Considering acquisition of one or more private companies (including subsidiaries or assets of a public company) in the next two years; and



Practical Tip: An Acquisition Shelf Checklist (Cont'd)

- Likely to use stock as a significant portion of acquisition consideration.

Deliver the acquisition shelf prospectus (which need not describe the acquisition itself) to the target company's shareholders:

- To insiders, when negotiations begin; and
- To other shareholders, at least 20 business days in advance of any shareholder vote or closing of the acquisition.

Some acquiring companies, to ensure delivery of all material information, also deliver to the target company's shareholders copies of all the documents incorporated by reference into the acquisition shelf prospectus. The target company usually simultaneously delivers to its shareholders an information statement that describes the terms of the transaction and relevant information.

- If an acquisition, or a series of smaller acquisitions, is material for financial statement purposes, then the acquiring company will file a current report on Form 8-K or a post-effective amendment to the acquisition shelf Form S-4 containing full Regulation S-X – required financial statements.
- Affiliates of the target company who become affiliates of the acquiring company will become subject to Rule 144 for their resales. (We discuss Rule 144 in Chapter 4.)

Benefits of the Acquisition Shelf. The acquisition shelf has a number of benefits, including the following:

- Because shares issued under an acquisition shelf Form S-4 are registered, those shares generally are freely transferable by shareholders of the target company;

- Companies can use an acquisition shelf at any time after the registration statement is declared effective, allowing an acquiring company to close a private company acquisition quickly; and
- In many cases, companies can keep their shelf registration statement current through incorporation by reference of their 1934 Act reports.

Downsides of the Acquisition Shelf. Some companies will view as downsides, the facts that:

- Any acquisition shelf filing will signal the company's acquisition appetite to competitors and the market; and
- Analysts and shareholders may view the registered shares negatively as "overhang."

Registration Statements on Form S-8

Form S-8 is available for 1934 Act reporting companies to register securities offered to employees, directors and certain consultants under any employee benefit plan, such as an equity incentive plan. The requirements for the use of Form S-8 are much simpler than those for other registration forms. Additionally, a registration statement on Form S-8 is not reviewed by the SEC before it becomes effective – it is effective immediately upon filing. Like Form S-3, Form S-8 allows a company to incorporate by reference all current and future 1934 Act reports filed by the company. In the IPO context, the company's prospectus included in its Form S-1 is typically incorporated by reference into the Form S-8. An IPO company usually will file a Form S-8 immediately after the effectiveness of its registration statement on Form S-1.

Practical Tip:

**File Your Form S-8 Immediately
After Your IPO, and Limit Option Exercise Until Then!**



The securities law mechanics for granting equity awards to your employees change after your IPO. Private companies typically grant stock options or other compensation-related



**Practical Tip:
File Your Form S-8 Immediately
After Your IPO, and Limit Option Exercise Until
Then! (Cont'd)**

equity to employees pursuant to the exemption from registration under Rule 701 under the 1933 Act, while public companies register the shares to be issued under an equity incentive plan with the SEC on a Form S-8. Stock acquired by an employee under Rule 701 (by exercise of a stock option, for example) may generally be sold 90 days *after* your IPO. However, if your company registers outstanding pre-IPO awards on a Form S-8 immediately after the IPO, employees can resell shares acquired under those awards without the 90-day waiting period. To take advantage of that benefit, file your Form S-8 immediately after the IPO, registering both outstanding pre-IPO awards and the shares available for future grant under your company's plan. Shares that an employee purchases under Rule 701 *before* the Form S-8 is filed cannot be registered on a Form S-8, so you should ask your employees not to exercise any stock options until the Form S-8 is filed to avoid the 90-day waiting period. (Go ahead and grant options – just hold off on exercises until the Form S-8 is on file.)

Unlike Form S-3, however, Form S-8 does not require the company to file a prospectus with the SEC, but merely to provide employees with a prospectus containing specified information, including a description of the material terms and tax consequences of the equity incentive plan.

Registrant Requirements

To be eligible to use Form S-8, the registrant must:

- Be subject to the 1934 Act reporting requirements immediately prior to filing the Form S-8;
- Have filed all 1934 Act reports required to be filed during the preceding 12-month period (or for such shorter period that the company has been subject to 1934 Act reporting requirements);

- Not be a shell company and not have been a shell company for at least 60 days before filing the Form S-8; and
- If the company was at any earlier time a shell company, have filed current Form 10 information with the SEC, which filing reflected that it is no longer a shell company, at least 60 days before filing the Form S-8.

A business combination-related shell company may, however, use Form S-8 as soon as it ceases to be a shell company and files its current Form 10 information with the SEC.

Transaction Requirements

A company that meets Form S-8's registrant requirements can use Form S-8 to register securities offered to employees under any written option, purchase, savings, bonus, appreciation, profit-sharing, thrift, incentive, pension or similar employee benefit plan, or a written compensation contract. (We discuss the special meaning of the term *employees* for purpose of Form S-8 later in this chapter.)

Stock issued for options exercised under an equity incentive plan before an IPO cannot be registered on a Form S-8 even though outstanding options under that plan are registrable on Form S-8 at the time of the IPO. Employees considering whether to exercise any options immediately prior to an IPO should be advised of this.

Practical Tip: Beware of Restricted Stock



A company may register shares underlying stock options at any time before the options are exercised, either before or after the options are granted. However, for restricted stock (stock subject to forfeiture restrictions that lapse over time), the Form S-8 must be effective before the company grants and issues the restricted stock.

Definition of Employee

In general, Form S-8 is available only to register securities offered to *employees*. The term employee for Form S-8 purposes includes any employee, director, general partner or officer of the company. (It also includes trustees in the case of a business trust.) Former employees (as well as any executors authorized by law to administer the estates or assets of former employees) are also employees, but only for the following purposes:

- Exercising stock options and subsequent sales of securities to the extent permitted by the relevant plan; and
- Acquiring securities pursuant to intraplan transfers among plan funds to the extent permitted by the relevant plan.

Employees can also include consultants and advisors who are natural persons and provide bona fide services to the company. Their services cannot, however, be in connection with an offer or sale of securities in a capital-raising transaction or for promoting or maintaining a market for the company's securities.

Transferable Options

Form S-8 registration permits the exercise of employee stock options by any family member who has acquired the options from an employee through a gift or a domestic relations order. Form S-8 is not available for the exercise of stock options that have been transferred for value.

Filings Relating to Employee Benefit Plan Amendments

From time to time, a company may choose to amend an employee benefit plan for which it has filed a registration statement on Form S-8. The question then is how to amend the Form S-8 relating to offerings under that plan. This is especially an issue when an amendment has the effect of changing the number of shares available for issuance under the plan.

- If a plan amendment increases the number of shares available for issuance under the plan, the company may register the additional shares using an abbreviated Form S-8 filing. (This would be a new registration statement, not a post-effective amendment to the Form

S-8 originally registering the plan.) The abbreviated Form S-8's exhibits would include a new legal opinion and accountant's consent.

- If a plan amendment decreases the number of shares available for issuance under the plan, the company should file a post-effective amendment deregistering that number of shares. The company would not need to file a new legal opinion or accountant's consent for this filing.
- If a plan amendment changes the terms of the plan without changing the number of shares available for issuance under the plan, a post-effective amendment would generally not be necessary. Instead, the Form S-8 would self-update by incorporating by reference a 1934 Act report (for example, a Form 8-K or 10-Q) that describes the amendment or files the amendment as an exhibit.

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Chapter 12

Securities and Corporate Governance Litigation

A public company and its management face litigation risks as a result of issuing public securities. Securities holders may bring claims under the federal securities laws for alleged disclosure violations. Shareholders may bring corporate governance claims, such as derivative claims for breaches of fiduciary duty by management. The SEC or the company's securities exchange may conduct investigations and bring enforcement proceedings against the company or management for disclosure violations. Criminal prosecutors may investigate and prosecute criminal violations of the securities laws.

Although these risks are real, it is possible to conduct business as a public company in a way that mitigates them and provides increased protection to directors and officers. This chapter summarizes some of the most common litigation risks facing public companies and their officers and directors and provides practical tips for managing these risks.

Liability Under the 1934 Act – Section 10(b) and Rule 10b-5

The most common cases brought by public company securities holders are private securities actions under the 1934 Act, the federal law governing the securities markets. Section 10(b) of the 1934 Act and Rule 10b-5 make it unlawful for a company or a person, in connection with the purchase or sale of a security, to:

- Make any untrue statement of a material fact; or
- Omit to state a material fact necessary in order to make a statement made, in light of the circumstances under which it was made, not misleading.

In practical terms, a company or a person violates Rule 10b-5 by making an intentional or reckless misrepresentation or omission of fact that influences the price of a public company's stock. Rule 10b-5 applies to virtually any type of statement by a public company, officer or director, including statements in periodic reports, press releases and analyst calls. Purchasers or sellers of stock can sue even if they did not see, hear or rely on the alleged misstatement in deciding to purchase a company's stock. These purchasers and sellers rely on the *fraud on the market* presumption, which allows them to allege that they relied on the integrity of the market price for the stock to reflect all publicly available material information. Rule 10b-5 imposes liability even when a person or company was not a party to a securities transaction, such as when an investor buys stock via a transaction on a stock exchange.

A company, its officers and directors, and any other person who makes a false or misleading statement may be directly liable for damages under Rule 10b-5. Those who control the company may also be liable – even if they did not personally make any false or misleading statements.

Although liability under Rule 10b-5 is broad, there are some important limitations. A company or person is not liable for mere negligence. Instead, Rule 10b-5 imposes liability only on a defendant who acts with *scienter*, which means with knowledge of or reckless disregard for the falseness of a statement or the materiality of an omission. In addition, a defendant is liable only for economic losses actually caused by the alleged misrepresentation or omission. In light of these limitations, defendants often assert a multi-pronged defense to claims under Rule 10b-5, arguing that the:

- Statement was not false or misleading, or the omission was not material;
- Defendants did not know or recklessly disregard the fact that the statement was false; and
- Alleged misrepresentations or omissions did not cause the economic losses allegedly suffered by the plaintiffs.

Practical Tip:
If You Speak Up, Speak the Whole Truth



Rule 10b-5 does not impose an affirmative duty to disclose all material information about your company's business. But when you do speak, you must do so truthfully. For example, while your company may have no obligation to disclose the development of a new product, if you choose to announce the new development, your statements must be accurate and complete.

Liability Under the 1933 Act – Sections 11 and 12(a)(2)

In some circumstances, public company shareholders may also bring claims under a second federal law, the 1933 Act, that governs security offerings. Claims under the 1933 Act are less common than claims under the 1934 Act because they are limited to false or misleading statements made in connection with a registered offering of securities. Claims under the 1933 Act, however, can be even more threatening than a Rule 10b-5 claim, since plaintiffs asserting 1933 Act claims need to allege little in the way of actual misconduct in order to defeat a motion to dismiss those claims and proceed to take discovery. The risk of legal claims under the 1933 Act provides a powerful incentive to issuers and their agents to ensure the accuracy of registration statements and prospectuses.

Two sections of the 1933 Act, Sections 11 and 12(a)(2), impose liability for misstatements in registration statements and prospectuses. Those sections often overlap, but they are not identical. They have different elements and provide for recovery of different types of damages.

Section 11 – Liability for Misrepresentations in a Registration Statement

Section 11 of the 1933 Act permits shareholders to recover damages for misstatements or omissions of material facts in a registration statement – including the prospectus. With limited exceptions, Section 11 does not require a plaintiff to prove that she relied on the alleged misstatement, nor that the defendant acted

with scienter (the requirement of knowledge or reckless disregard that a statement was false or misleading for claims under the 1934 Act). To state a claim under Section 11, a plaintiff generally must prove only that the:

- Registration statement or prospectus misrepresented or omitted a material fact at the time it became effective;
- Plaintiff bought securities traceable to that registration statement; and
- Plaintiff suffered damages (typically a loss due to a decline in the price of a security).

A shareholder may bring a Section 11 claim against, among others:

- The company issuing the securities;
- Any director of the company at the time of the offering; or
- Any person who signed the registration statement.

Other potential Section 11 targets include any person who controls these primary defendants, as well as underwriters and accountants.

Directors and officers of the company (but not the company) and some other defendants may assert an affirmative defense of reasonable care. In addition, all defendants may have available the affirmative defenses that:

- The misstatement or omission, if it occurred, did not cause the plaintiff's damages; and
- The plaintiff knew the truth when she purchased the securities.

Section 12(a)(2) – Seller's Liability

Section 12(a)(2) of the 1933 Act provides shareholders with a right to sue for a misstatement or omission of material fact in a prospectus or oral communication used to offer or sell securities to the public. Any investor who purchases a security in a public offering can assert a Section 12(a)(2) claim against any person who offers or sells the security. Section 12(a)(2) applies only to sales of securities in public offerings, not to trading in the secondary market or to private sales of securities. It also applies only against those considered to be *sellers* of the securities at issue. Within those parameters, Section 12(a)(2) imposes relatively few requirements on a plaintiff. A plaintiff need not

prove reliance, scienter or that the misstatement or omission caused the purchase. In order to recover, a plaintiff must prove only that:

- The defendant offered or sold securities;
- By the use of any means of interstate commerce (such as an interstate mailing or telephone call);
- Through a prospectus or oral communication;
- Which included a misstatement or omission of material fact; and
- The plaintiff was ignorant of the truth.

A defendant may assert an affirmative defense of reasonable care, i.e., the defendant did not know, and in the exercise of reasonable care could not have known, of the misstatement or omission.

A successful plaintiff who still holds the security is entitled to rescission and may recover the consideration paid for the security, minus any income. Where the plaintiff has sold the security, the plaintiff may recover rescissionary damages, generally the difference between the purchase price and the resale price, plus interest, and minus any income or return of capital on the security.

Special Situations Under the 1933 and 1934 Acts

Forward-Looking Statements

Forward-looking statements, such as forecasts of earnings or revenues, have historically served as the basis for private claims under the 1933 and 1934 Acts. In order to encourage companies to make forward-looking statements, Congress created, in the Private Securities Litigation Reform Act of 1995 (1995 Reform Act), a safe harbor defense for forward-looking statements against federal securities law claims. Under this safe harbor, a forward-looking statement cannot be the basis for liability if the company:

- Properly identifies the statement as a forward-looking statement; and
- Accompanies the statement with meaningful cautionary statements that identify important factors that could cause actual results to differ materially from those forecast in the forward-looking statement.

A company does not need to identify all important factors, or even the factor that ultimately causes actual results to differ from those forecast in the forward-looking statement, as long as it issues the most complete cautionary statements possible in the circumstances. (We provide practical guidance on this safe harbor in Chapter 3.)

Liability for Endorsing Third-Party Statements

A company or person may be liable for false or misleading statements made by stock analysts or other third parties if that company or person:

- Gives false or misleading information to the analyst or third-party;
- Expressly or implicitly adopts the third-party statements as its own (for example, when the defendant has so entangled itself with the third-party statements that the statements are, in effect, attributable to the defendant); or
- Endorses or adopts the third-party statements after publication, such as by distributing the statements to the public.



Practical Tip: How to Avoid Liability for Endorsing an Analyst's Report

Your company can take three basic steps to minimize the risk of liability for statements in a stock analyst's report:

- Enforce your company's policy of neither endorsing nor adopting statements made by analysts;
- Do not provide links to analyst's reports on the company's website or otherwise distribute analysts' reports to shareholders or other members of the public; and
- Comply with Regulation FD. (We explain how in Chapter 3.)

Duty to Correct and Duty to Update

A company has a duty to correct a material statement of historical fact that the company discovers to have been untrue when made. The company must correct the prior statement within a reasonable time after learning that the original statement of historical fact was not true when a failure to correct would affect the total mix of information available for investors to use to make informed investment decisions. In contrast, there is no general duty to update statements that were true when made. Frequently, the passage of time causes a forward-looking statement, although reasonable when made, to become outdated or, if viewed as a current statement, to be materially misleading. Because it may be difficult to determine when an earlier statement has become materially misleading in light of developments, the best practice is to identify statements as accurate only on and as of the date they are made and explicitly disclaim any intention or obligation to update them.

Shareholder Class Actions

Plaintiffs often bring claims under the 1933 and 1934 Acts as *shareholder class actions*. A shareholder class action is a lawsuit brought by a purchaser or seller, or a relatively small group of purchasers or sellers, on behalf of all investors who purchased or sold securities during a specified time, known as the *class period*. Plaintiffs and their lawyers often file shareholder class actions when a negative public announcement by a company triggers a drop in the company's stock price.

A shareholder class action typically begins with several plaintiffs filing complaints, which are then consolidated into a single class action complaint. The company and other defendants often move to dismiss the complaint on the ground that the complaint fails to allege facts that satisfy the legal standards relevant to the cause of action. If the court grants that motion, the court dismisses the case either:

- *With prejudice*, meaning that plaintiffs are not entitled to amend and refile a complaint making the same legal claims based on the same alleged misconduct (such a decision may be subject to appeal); or
- *Without prejudice*, meaning that plaintiffs have an opportunity to correct any defects in the complaint and refile a complaint making legal claims based on the same alleged misconduct.

If the court denies the motion to dismiss, the case proceeds to the discovery phase. Because most securities lawsuits cover an extended period and multiple aspects of a company's operations and financial condition, discovery can be extensive, costly and time-consuming. Once the plaintiff obtains access to extensive internal records of the company, the plaintiff's theory of what was not properly disclosed often changes and expands.



Practical Tip:
Named in a Shareholder Class Action?
Take These Four Steps

As soon as a plaintiff names you or your company in a shareholder class action, you should promptly take these four basic steps:

- ✓ Consult your insurance broker and give timely notice of the lawsuit, including a copy of the complaint, to the company's D&O liability insurance carriers.
- ✓ Research and retain outside legal counsel experienced in securities litigation. Choose qualified counsel with good practical judgment. Because discovery in these cases can be unusually burdensome, it is helpful if your legal counsel knows the company well. You may be working closely with these lawyers for an extended period of time, and you should feel comfortable with them and confident in their abilities.
- ✓ Work with legal counsel to preserve documents relating broadly to the subject matter of the lawsuit. Counsel will identify which documents should be retained and by whom. Preserve both paper documents and electronic documents and data.
- ✓ Develop strategies and goals for handling the lawsuit. The first step in nearly all securities lawsuits is to move to dismiss the complaint. But plan beyond the motion to dismiss because the case may begin to move quickly if the court denies the motion to dismiss.

Securities Litigation After Sarbanes-Oxley and the Dodd-Frank Act

Sarbanes-Oxley and the Dodd-Frank Act have had only a modest impact on private securities class actions. However, the statutes have contributed to an increase in enforcement activity by the SEC and other government officials and have had a significant effect on how companies are expected to respond to reports of wrongdoing.

Breaking News: The Dodd-Frank Act Gives the SEC a New Enforcement Tool



In July 2010, the president signed the Dodd-Frank Act into law, largely in response to the recent financial crisis. The Dodd-Frank Act enhances the enforcement and investigatory powers of the SEC in three critical ways.

- Loosens the state of mind requirements to prosecute charges of aiding and abetting violations of the federal securities laws, making it easier for the SEC to establish liability on these types of claims. The prior standard required that an aider or abettor *knowingly* provide substantial assistance in connection with another person's violations, but the Dodd-Frank Act provides for liability against those who aid or abet another's violations *knowingly or recklessly*.
- Creates monetary incentives for whistleblowers who provide information leading to an SEC enforcement action and financial recovery of more than \$1 million. Incentives range from 10% to 30% of collected funds.
- Allows the SEC to issue a subpoena to compel the attendance of a witness at trial from any place within the United States, with no limits on the distance to be traveled. Prior to the Dodd-Frank Act, the SEC could only compel witnesses to travel from a radius of 100 miles around the courthouse to provide testimony at trial. If an important witness was located more than 100 miles from the courthouse where the SEC's case was being tried, the SEC was required to introduce videotaped deposition testimony by that witness.

CEO/CFO Certifications

Sarbanes-Oxley generally requires the CEO and CFO to certify their company's periodic reports. The certification requirement itself does not appreciably increase the potential liability of a CEO or CFO in securities class actions. However, private plaintiffs have used the certifications to focus claims more directly on the CEO and CFO or to suggest that, based on those officers' required review of a periodic report, they knew, or were reckless in not knowing, that the periodic report contained material misrepresentations or omissions. The SEC uses certifications in enforcement proceedings and related litigation. (We discuss practical tips for compliance with the certification requirements in Chapter 2.)

Extension of Statute of Limitations

Sarbanes-Oxley extended the statute of limitations for private securities lawsuits that assert fraud, deceit, manipulation or a contrivance in contravention of a regulatory requirement. Claims subject to the statute of limitations must be brought not later than the earlier of:

- Two years after discovery of the violation (up from one year before Sarbanes-Oxley); or
- Five years after the occurrence of the violation (up from three years before Sarbanes-Oxley).

Because the extended statute of limitations applies only to claims involving fraud, deceit, manipulation and similar misconduct, most courts have held that it applies to claims under Rule 10b-5 but not to claims under Section 11 of the 1933 Act.

Retention and Destruction of Documents

Accountants are now required to retain a broad range of documents relating to audits or reviews of a company's financial statements, including audit and review work papers, for seven years from the end of the fiscal period in which the audit or review was conducted. An auditor must retain these materials whether they support or are inconsistent with the auditor's final conclusions. In addition, Sarbanes-Oxley imposed criminal liability on any person – not only an auditor – who “corruptly” alters, destroys, mutilates or conceals a document or other record with the intent to impair its integrity or availability for use in an official proceeding. These changes, along with court decisions regarding spoliation of

evidence, changes in procedural rules and evolving standards of practice have all elevated the importance of companies' document management practices.

Practical Tip: Creating a Document Management Policy



To protect your company and your employees, your company's document management and retention policy should include four elements:

- A document *creation* policy: Encourage professionalism in written communications, prohibit the use of profane language, unfounded gossip or speculation, and encourage face-to-face discussion to resolve issues. You don't have to manage a misleading or unduly embarrassing document that is never created.
- A document *retention* policy: Identify which documents to retain, the retention period for different classes of documents, and the procedures to follow. Consult with tax, regulatory affairs, legal and other personnel to determine the appropriate retention period for each category of documents. Retained documents should include both important business records and documents necessary to satisfy government requirements.
- A document *destruction* policy: Set out procedures for destroying documents that do not need to be retained, such as personal correspondence, nonessential emails, drafts of documents, and records that have passed their retention dates.
- Clear standards for suspending document destruction practices and preserving records, along with clear responsibilities for compliance: When litigation (or an investigation or other official proceeding) commences, or is reasonably foreseeable, then preserve all relevant documents. Destroying relevant documents under those circumstances – or under any other circumstance that might suggest an intent to make the documents unavailable in the lawsuit, investigation or other official proceeding – may subject the company and its employees to sanctions for destroying evidence or even criminal charges for obstruction of justice. There is no bright-line test, so err on the side of caution.

Standards of Professional Conduct for Attorneys

The SEC's *up-the-ladder reporting* rules require attorneys to report evidence of material violations of state or federal law to a company's senior management. If senior management does not respond appropriately, the reporting attorney is required to report the violation to a committee of independent directors or to the full Board. The SEC has proposed a rule to require an attorney to withdraw from representation of a company and to notify the SEC if senior management or the Board does not respond appropriately to the reported violation, but has taken no actions since 2003.

Securities Debts Survive Bankruptcy

One of the more obscure provisions of Sarbanes-Oxley amended the Bankruptcy Code to provide that some debts arising from claims under federal or state securities law and common law securities fraud are not dischargeable in bankruptcy.

Whistleblower Protection

Sarbanes-Oxley provides protection from retaliation for employees, agents and contractors who lawfully provide information or otherwise assist investigations being conducted by a federal regulatory or law enforcement agency, a congressional member or committee, or any supervisor of the employee. The protection extends to employees who participate in proceedings alleging violations of selected federal statutes and regulations.

Employee Retirement Income Security Act of 1974 (ERISA) Claims

ERISA is a federal law that governs private pension plans and other employee benefit plans. Because most public companies have ERISA plans, and because those plans typically allow employees to invest in the company's securities, decreases in a company's stock price can trigger claims under ERISA similar to claims under the federal securities laws. ERISA plaintiffs (company employees) often claim that company executives, who had a fiduciary duty to employees under an employee benefit plan, concealed some fraud or misrepresentation from employees. If the employees had

possessed that knowledge, plaintiffs argue, they would not have invested in the company's stock as part of their benefit plan investment. Because ERISA is in some ways more plaintiff-friendly than the federal securities laws, employees often assert ERISA claims in addition to their federal securities law claims (or separately assert both types of claims at the same time).

Much ERISA litigation focuses on breaches of fiduciary duties. Whether a court will find a person to be a fiduciary for purposes of ERISA will depend on the particular activity at issue. A person is considered a fiduciary for purposes of ERISA to the extent that she:

- Exercises any discretionary authority or control with respect to management of an ERISA plan or its assets;
- Provides investment advice for a fee or other compensation or has discretionary authority or responsibility to do so; or
- Has any discretionary authority or responsibility in the administration of an ERISA plan.

A court can find fiduciary status either by explicit reference in plan documents or because the individual engaged in conduct that is fiduciary in nature. Accordingly, officers and directors may be found to have fiduciary status for ERISA plans. A fiduciary who is found to have breached his fiduciary duties to the ERISA plan may be held personally liable to participants in the plan for the plan's losses resulting from the fiduciary's breach.

Corporate Governance Litigation

In addition to claims under the federal securities laws, directors and officers of a public company may also face claims in connection with the corporate governance issues that we discuss in Chapters 7, 8 and 9. Corporate governance litigation often involves alleged conflicts of interest. (We discuss ways to manage conflict-of-interest situations in Chapter 7.)

Change-of-Control Situations

Change-of-control transactions are especially fraught with potential conflicts of interest for directors and are a common source of litigation, whether brought by frustrated potential acquirers or by shareholders dissatisfied with the terms or outcome of a transaction.

For example, shareholder plaintiffs often allege that directors have approved a merger or other change-of-control transaction in order to entrench themselves, to obtain benefits for themselves or to benefit a favored shareholder. The duty of the Board in a change-of-control situation is fairly clear, at least in theory:

- The Board must act in the best interests of the company and all of its shareholders; and
- If the Board decides to sell the company, it generally must take reasonable steps to obtain the best available price and cannot unduly favor a lower-valued transaction.

Courts apply an enhanced level of scrutiny when reviewing directors' behavior in the face of a takeover threat. In order for their decision in a change-of-control situation to be protected under the business judgment rule, directors must agree to the transaction offering the best value reasonably available for the company's shareholders. Use the three methods that we describe in Chapter 7 for dealing with conflicts of interest in a change-of-control situation to help protect the directors from liability.

The sale of a company will generally trigger dissenters' rights (provisions in the governing corporate statute that allow for judicial review of price). Careful compliance with these provisions can result in preemption of shareholder claims for monetary relief in favor of a statutory appraisal process. (The statutory dissent process will not preempt claims for injunctive relief or claims for fraud, misrepresentation or other serious impropriety.)

Derivative Lawsuits

Plaintiffs frequently pursue corporate governance claims through *derivative lawsuits*. In a derivative lawsuit, a shareholder sues on behalf of the company, seeking relief for alleged claims the company owns but has failed to bring itself. A derivative plaintiff cannot recover damages personally; instead, any damages or injunctive relief inure solely to the benefit of the company. A company's officers and directors are the most common targets of derivative claims, although plaintiffs also may target major shareholders and third parties.

Derivative plaintiffs generally comply with strict procedural requirements:

- The plaintiff must be a shareholder at the time of the alleged wrong and remain a shareholder throughout the litigation;

- The plaintiff must be an adequate representative of the company's other shareholders;
- The company usually must be made a party to the litigation, generally as a nominal defendant; and
- Before bringing suit, the plaintiff must make a demand upon the Board that the company take steps to assert the claim.

Some states (but not all) permit a plaintiff to proceed without first making a demand upon the Board if the plaintiff can establish that such a demand would be futile by establishing a reasonable doubt that:

- The directors acted disinterestedly and independently; and
- The directors exercised valid business judgment in authorizing the challenged transaction.

A company may assume control of derivative litigation by appointing a *Special Litigation Committee* of the Board to investigate the claims asserted by a derivative plaintiff and determine whether pursuing the claims is in the best interests of the company. A Special Litigation Committee will have the power to terminate, settle or pursue the litigation, and may decide to permit the existing plaintiff to continue the suit. The Board should appoint disinterested independent directors to a Special Litigation Committee and give the Special Litigation Committee full authority to accomplish its investigation and to implement its decisions. Courts will often grant motions to stay derivative suits, including burdensome discovery, pending the outcome of Special Litigation Committee investigations. Any decision by a Special Litigation Committee to terminate the litigation will be subject to judicial review, and a party challenging the termination decision may pursue limited discovery into the independence and good faith of the Special Litigation Committee's investigation.

Alternatively, the Board may ask an advisory committee of independent directors to conduct an investigation and report the results to the full Board. The full Board will then determine how best to respond to the derivative litigation based on the independent committee's recommendations. The risk of this approach is that to the extent that a derivative plaintiff has alleged

that the full Board has some interest or involvement in the alleged misconduct or lacks independence, courts are less likely to defer to the independent committee's recommendations, and the full Board's review, than to a Special Litigation Committee composed of independent directors authorized to act independently on the results of an investigation.



Practical Tip:
**The Lonely Life of the One-Member
Special Litigation Committee**

A Special Litigation Committee (or any other special Board committee) must be composed of directors who are disinterested and independent. In many Model Business Corporation Act states, a minimum of two directors may be required, but in Delaware and some other states, a committee may be composed of only one director. In the words of one court, “[i]f a single member committee is to be used, the member should, like Caesar’s wife, be above reproach.” As a practical matter, the independence of a single-member committee may come under more rigorous scrutiny than would otherwise be applied to individual members of a larger committee.

Once a plaintiff has initiated a derivative action, the parties will need court approval to settle or dismiss it. In most derivative cases, notice of a settlement must be provided to the shareholders, and the court will convene a hearing to determine whether the settlement is fair and adequate. Attorneys’ fees may be awarded to plaintiff’s counsel – either out of the proceeds of the settlement or from the company itself – if the court determines that counsel’s efforts conferred a substantial monetary or nonmonetary benefit upon the company.

Shareholder Access to Corporate Books and Records

Statutes in numerous states, including Delaware, permit shareholders of public corporations to inspect some of a company’s books and records upon request made to the company with sufficient advance notice. The statutes of the state in which the company

is incorporated govern these inspections. In most cases, a shareholder must express a *proper purpose* for a books and records inspection request. Courts have generally upheld as *proper purposes* a shareholder's desire to:

- Investigate possible wrongdoing or mismanagement by company executives;
- Appropriately value shares of plaintiff company's stock; and
- Communicate with other shareholders regarding proposals for shareholders' meetings.

States vary in the type of corporate books and records that they permit shareholders to access, but they usually include at least the company's certificate or articles of incorporation, bylaws and minutes of shareholders' meetings. Shareholder inspection demands are often simply the prologue to a later event, such as shareholder derivative litigation, a request for a meeting with directors for the purpose of discussing proposed reform, preparation of shareholder resolutions or a for proxy fight.

Foreign Corrupt Practices Act

A key subset of federal security laws is the Foreign Corrupt Practices Act of 1997 (FCPA). The FCPA has two key components. First, *anti-bribery provisions* prohibit public and private companies from paying bribes or giving anything of value in order to influence a foreign official. Second, *books and record provisions* mandate that public companies maintain books and records in sufficient detail to be "reasonable" to a prudent manager of the business. Promising, offering or authorizing someone to pay a bribe or to give something of value to a foreign official may all violate the FCPA. The FCPA goes beyond cash, to include goods, services, rights, contracts and benefits. *Foreign official* may include any foreign government party or public international organization representative, a candidate for public office or an employee of a government-owned business. Violation of the FCPA can result in criminal penalties, including prison terms for individuals, as well as monetary fines. The Department of Justice and the SEC, who jointly enforce the FCPA, have made FCPA a top enforcement priority.



**Practical Tip:
Help Your Employees to Steer Clear –
and Record It!**

Four key practices to keep your company FCPA compliant:

- Maintain a robust compliance program designed to scrutinize requests for reimbursement for gifts by employees or consultants who engage in foreign business for your company.
- Include appropriate third-party reviews in your record. Check in on suppliers, resellers, distributors and agents.
- Have a rigorous due diligence process for any acquisition that involves doing business abroad.
- Enhance and test a robust whistleblower system. Tie it to internal training!

Regulatory Investigations and Enforcement

SEC

Each year the SEC brings hundreds of civil enforcement actions against companies and individuals that are alleged to have violated the federal securities laws for:

- Insider trading;
- Accounting fraud;
- Disclosure violations; and
- Aiding and abetting violations.

The SEC will often first seek an immediate injunction against defendants to prohibit unlawful acts and practices. It may then seek disgorgement, monetary penalties and other sanctions against the alleged wrongdoers. While the SEC does not have the authority to pursue criminal actions, it may refer criminal matters to the Department of Justice.

The SEC initially pursues investigations through an informal inquiry, interviewing potential witnesses and examining brokerage records, trading data or company documents, in order to determine whether further investigation is warranted. Following the preliminary investigation, if the SEC issues a formal order of investigation, the SEC Staff may issue subpoenas compelling witnesses to testify and produce books, records and other relevant documents to assist the SEC in its investigation. The SEC can authorize its staff to file a case in federal court or to bring an administrative action against individuals and companies.

FINRA Regulation of Nasdaq and Other Exchanges

In addition to the SEC's civil enforcement authority, securities markets have established self-regulatory organizations to govern the conduct of their members. The Financial Industry Regulatory Authority, Inc. (FINRA) is the largest independent regulator for U.S. securities firms. FINRA was created in July 2007 as a result of the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement and arbitration functions of the NYSE. FINRA is involved in virtually all aspects of the securities business, including registering and educating industry participants, examining securities firms, rulemaking, enforcing its own rules as well as the federal securities laws, and administering a dispute resolution forum for investors and registered firms. FINRA performs market regulation under contract for The Nasdaq Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange.

FINRA investigates trading in public company stock through its Market Regulation department. Most often, FINRA initiates these investigations to look into suspicious trading in connection with a significant public announcement by a company, such as the announcement of a merger agreement. *Market Regulation* will routinely collect information concerning company personnel who had knowledge of the relevant inside information pertaining to the announcement before it was made public, as well as a chronology of the events within the company relevant to the subject matter reflected in the public announcement. FINRA investigations are serious and may merit the assistance of qualified counsel to help ensure compliance.

NYSE Regulation

NYSE Regulation, Inc. is a not-for-profit corporation dedicated to enforcing marketplace rules, listing standards and federal securities laws for NYSE-listed companies. The organization consists of three divisions: Market Surveillance, Enforcement and Risk, and Listed Company Compliance.

Enforcement and Risk investigates and prosecutes violations of NYSE rules and applicable federal laws or regulations that occur on or through NYSE systems and facilities. Enforcement cases grow from investor complaints, examinations of member organizations and referrals from the SEC. Insider trading, market manipulation, short sale violations, books and records deficiencies, and other cases can lead to sanctions that range from a censure or fine to a suspension, expulsion or bar from membership, employment or association with any NYSE member or member organization.

SEC, Department of Justice and State Securities Regulators Are Active

Regulators have enforced the securities laws more vigorously in recent years. The SEC has brought more enforcement actions and has sought more serious sanctions, including prohibiting directors and officers from serving for public companies and other more severe penalties (such as fines and disgorgement). The SEC has also turned a keen eye to gatekeepers (including chief legal officers) and third parties who aid and abet alleged violations of the securities laws. The Department of Justice has likewise been more active, bringing hundreds of criminal cases for alleged corporate fraud.

Sarbanes-Oxley and the Dodd-Frank Act contributed to these developments by providing more resources to the SEC and giving the SEC expanded powers. Sarbanes-Oxley, for instance, gives the SEC greater authority to bar individuals from serving as officers or directors of public companies, permits the SEC to recover profits earned by certain insiders in the case of an accounting restatement, and allows the SEC to obtain a freeze order barring an issuer from making certain extraordinary payments during the pendency of an SEC investigation.

Since 2008, the Madoff fraud and the collapse of the credit markets have provided a renewed impetus to these trends, resulting in additional resources for government investigators and prosecutors and greater demand for vigorous enforcement of the securities laws.

**Practical Tip:
Create and Monitor an Effective
Compliance Program**



Companies can be criminally liable for crimes that employees have committed in connection with their employment. In determining whether to charge a company for an employee's wrongdoing, prosecutors and regulators often ask: Did the company have an effective compliance program to detect and prevent violations of law? Protect your company with a compliance program that:

- Includes clear written standards and procedures;
- Names a single person or small team responsible for overseeing the compliance program;
- Expects CEO and senior management to set the appropriate tone at the top;
- Provides appropriate training at all levels, including the Board and senior management;
- Monitors, audits, evaluates and promotes the reporting of potential and actual violations, including a confidential or anonymous reporting mechanism; and
- Holds employees accountable for violations of policy or law.

When a possible violation occurs – take prompt and reasonable steps to investigate, remedy or, as appropriate, report the violation.

**The Important Role of Directors' and Officers' (D&O)
Insurance**

Companies often purchase D&O insurance to protect directors and executives (as well as the company itself) from the types of claims and investigations described above. D&O insurance helps provide companies, directors and officers with the resources to defend and resolve such cases. D&O insurance also protects direc-

tors and officers from the risk that the company will be unable or unwilling to pay for a defense, settlement or judgment, such as where the company is insolvent or the claims are not subject to indemnification. For these reasons, D&O insurance is an essential element of any strategy to mitigate the litigation and investigation risks confronted by public companies and their directors and officers.

There are three common types of D&O insurance. We provide a visual guide to D&O insurance in Appendix 3.

- *Side A* coverage typically covers claims against officers and directors that are not indemnified by the company. Directors and officers can think of this as “worst case” coverage, which will be available to protect them if the company is unwilling or unable to make good on its indemnification obligations.
- *Side B* coverage typically reimburses the company for indemnified costs incurred in connection with claims against directors and officers. Since most solvent companies indemnify their directors and officers from such claims, policy payouts often involve this type of coverage.
- *Side C* coverage typically applies to claims against the company itself and is limited to securities claims.

D&O policies also routinely cover defense costs, and because D&O policies are wasting policies, the amounts paid for ongoing defense costs in connection with litigation or investigations will reduce the total insurance proceeds remaining for settlement or to pay a judgment or related expenses. D&O policies are almost always claims-made policies, meaning that coverage is provided for claims made during the policy period, rather than for conduct occurring during that period. As a result, it is essential that the company and the insured directors and officers provide their D&O carriers with prompt notice of any claims that might be covered. Any delay in providing notice could result in a loss of coverage.

Practical Tip:
**Be Vigilant – Manage Your Company’s D&O
Insurance Program**



Ensure that your company’s D&O insurance program provides protection – not only for the company but for the company’s directors and officers. Then:

- ☑ Review your company’s D&O insurance program annually with the broker and counsel to ensure that the program provides appropriate types and amounts of coverage.
- ☑ Ask how the policies will cover the potential gaps in your company’s D&O coverage layers that may result from one of the insurer’s insolvency. Be sure to analyze how the policy will apply in unusual situations, such as where the company becomes bankrupt, where one of the insurers becomes insolvent or where there is a government investigation.
- ☑ Ask for pricing on a Side-A-only D&O insurance program. An insurer offering Side-A-only D&O insurance will often be willing to allow its policy to “drop down” to fill a gap caused by the insolvency of an insurer providing a lower layer of insurance.
- ☑ Consider purchasing smaller insurance layers so that your company can fill any small gaps in coverage caused by insolvency of an insurer.
- ☑ Ask counsel to brief you on the order-of-payment language in D&O insurance policies. Does it provide that if directors, officers and the company all have simultaneous claims on the policy that exceed the liability limits, the directors and officers are entitled to payment before the company? This can ensure that the policies will not be seen as company assets in the event that the company enters bankruptcy.



Practical Tip:
**Be Vigilant – Manage Your Company’s D&O
Insurance Program (Cont’d)**

- Ensure that claims by the company’s bankruptcy trustee are not excluded from D&O insurance coverage under the policies’ likely “insured vs. insured” exception. (This bars coverage claims by one insured party against another.)
- Ask for confirmation that the policy has appropriate severability language that protects innocent directors and officers in the event one executive engages in wrongdoing. For example, ensure that the policy cannot be rescinded simply based on the fraud or misconduct of the CEO or CFO.

Chapter 13

Tiring of the Public Eye? Delisting, Deregistration and Going Private

At some point in their corporate life cycles, many companies delist, deregister or go private and cease making periodic filings with the SEC.

Delisting and Deregistration

Exchange Delisting (Section 12(b))

A public company registered under Section 12(b) of the 1934 Act can delist its securities voluntarily by application in accordance with the rules of its exchange. However, as long as the company has 300 or more shareholders, it will remain subject to the 1934 Act under Section 12(g) (companies of a certain size).

Size Criteria Delisting (Section 12(g))

A company can voluntarily terminate its registration of securities under Section 12(g) of the 1934 Act by filing a Form 15 certifying that either:

- The registered class of securities is held of record by fewer than 300 persons; or
- The registered class of securities is held of record by fewer than 500 persons and the total assets of the company have not exceeded \$10 million on the last day of each of the company's three most recent fiscal years.

The company's duty to file periodic and current reports is immediately suspended upon filing the Form 15, and its registration under the 1934 Act terminates 90 days after filing. The suspension will terminate if the company crosses the Section 12(g)

size thresholds as of the end of any future fiscal year. The suspension applies only to the duty to file periodic (Forms 10-K and 10-Q) and current (Form 8-K) reports. As long as the company is registered under Section 12(g), it will remain subject to the other obligations that attach to being registered (e.g., proxy rules and Section 16 reporting obligations) until 90 days after filing Form 15 when the company's Section 12(g) registration is terminated.

Suspension After Filing 1933 Act Registration (Section 15(d))

A company that issues equity or debt securities to the public in an offering registered under the 1933 Act must file annual, quarterly and current reports with the SEC under Section 15(d) of the 1934 Act. This reporting requirement applies even though the company does not list the securities on a national securities exchange or market and the company has not crossed the size thresholds triggering 1934 Act registration. Unlike registration under Section 12 of the 1934 Act, a company can never terminate its reporting obligations under Section 15(d) – those obligations may only be suspended. A company's periodic reporting obligations under Section 15(d) are automatically suspended for a fiscal year, other than a fiscal year in which a 1933 Act registration statement became effective, if at the beginning of that year the registered securities are held of record by less than 300 persons. A company must file a Form 15 with the SEC as a notice of the automatic suspension within 30 days after the beginning of the fiscal year in which the suspension is effective. If a company has one or more effective Form S-3 and/or Form S-8 registration statements, in order to rely on the Section 15(d) automatic reporting suspension, it must deregister any remaining unsold securities from those registration statements prior to filing its annual report on Form 10-K for the prior fiscal year. Otherwise the Form 10-K would serve as a post-effective amendment, rendering the automatic suspension under Section 15(d) unavailable.

A company may file a Form 15 under Rule 12h-3 under the 1934 Act to suspend its Section 15(d) reporting obligations at any time if it meets either of the record holder thresholds identified above for the termination of its Section 12(g) registration. However, like the Section 15(d) automatic reporting suspension, a company generally cannot rely on Rule 12h-3 to suspend its Section 15(d) reporting obligations for the fiscal year in which a 1933 Act

registration statement becomes effective or is updated by Section 10(a)(3) of the 1933 Act (e.g., by filing a Form 10-K). (In limited circumstances in connection with completion of a merger, a company may rely on Rule 12h-3 to suspend its Section 15(d) reporting obligations, even if a registration became effective or was updated in the same year.)

Going Private Transactions: Flying Below the Radar

In a going private transaction, a significant shareholder group (often insiders) offers to purchase all or most of the company's equity securities held by the general public. The company then files a Form 15 to deregister under the 1934 Act and will no longer have its stock publicly traded.

The Board of a public company may determine that a going private transaction is in the best interests of shareholders and the company for a number of reasons:

- *Small Float for Orphan Company.* A company with a small public float and little or no analyst coverage sometimes is unable to realize the benefits of being a public company. Stock prices for these types of companies, sometimes referred to as orphan public companies, may be undervalued and shareholders may have limited liquidity.
- *No Third-Party Purchasers.* The company may have sought and failed to find a third-party purchaser to maximize shareholder value.
- *Weary Outside Shareholders.* Outside shareholders may be prepared to liquidate their investment, while significant shareholders and management may not be ready to sell.
- *Liquidity.* A going private transaction will provide public shareholders with an opportunity to sell their shares at a premium to recent market prices.
- *Elimination of 1934 Act Reporting Obligations.* Going private relieves a company of the expenses and burdens of preparing and filing 1934 Act reports with the SEC, and complying with proxy requirements and stock exchange or market rules.

There are downsides to going private, including:

- *Cost, Decreased Liquidity and Loss of Public Profile.* Future cost savings may be offset by other considerations, such as:
 - The cost to complete the going private transaction;
 - Decreased liquidity for remaining shareholders;
 - A potentially heavy debt burden (if the transaction is financed); and
 - A loss of public profile or prestige compared to status as a public company.
- *Conflicts of Interest.* Going private transactions raise special concerns because the proponent typically has a conflict of interest. The proponent is frequently represented on the company's Board and has a fiduciary duty to the other shareholders, while it is in the proponent's personal financial interest to pay the minimum purchase price for the company.

The Process of Going Private

A going private transaction may take many forms, but the ultimate result is that the proponent acquires all or most of the outstanding stock, and the selling shareholders receive cash, redeemable preferred stock or debentures for their shares. The two most common transaction types are a self-tender or proxy solicitation to propose a merger.

Self-Tender. A company self-tender offer that buys out the general public will leave the proponent shareholder group holding a majority of the company's outstanding equity. The self-tender is followed by a second-step merger transaction in which all shareholders other than the proponent group are squeezed out.

Friendly Merger/Proxy Solicitation. Alternatively, the company can solicit shareholder proxies to merge the target company with an insider or an acquirer controlled by a third party. As with a self-tender, the proponent group will be left with a majority of the shares, and selling shareholders will receive cash or other consideration.

If any Board member has a conflict of interest in the transaction, the company's Board will often appoint a Special Committee of independent directors to review the proposal, negotiate with the proponent and make recommendations to the full Board. The Special Committee may retain independent counsel and a financial advisor to evaluate the proposed transaction and opine on the fairness of the transaction. (We discuss how to manage conflicts of interest in Chapter 7.) If the Board is unable to cleanse a conflict of interest, the transaction will be subject to entire fairness review, which includes demonstrating fair dealing and a fair price.

Rule 13e-3

Rule 13e-3 under the 1934 Act governs going private transactions and imposes significant disclosure requirements on a public company going private. Among other items, the company must disclose in the proxy statement or tender offer document filed with the SEC:

- The purpose of the transaction;
- Alternatives considered and reasons for their rejection;
- Reasons for the structure of the transaction and for undertaking it at this time;
- Why the issuer believes the transaction is fair;
- A discussion of the analysis underlying a financial advisor's fairness opinion;
- Firm offers made by any third party for the company during the past two years; and
- Extensive financial information.



Practical Tip: Key Players in a Going Private Transaction

Special Committee. A going private transaction often involves a conflict of interest between an insider proponent that may control the company and the other shareholders. The Board will want to ensure that a Special Committee is selected and granted broad authority. The Special Committee will have the ability to choose its own financial, legal and accounting advisors, and will become the voice of the Board in the transaction. The first significant act of the Special Committee is to choose its outside advisor.

Financial Advisor. The financial advisor will advise the Special Committee on the financial structure of the going private transaction and on strategic alternatives to the transaction. The Special Committee will also request that the financial advisor deliver a fairness opinion to the Special Committee. A fairness opinion is a statement by the financial advisor that the consideration or financial terms of the transaction are fair, from a financial point of view, to the company and its shareholders. Obtaining a fairness opinion is an important step in establishing that the Board has satisfied its fiduciary duty of care.

Information Agent. Even before the going private transaction begins, an information agent, typically, a proxy solicitation or consulting firm, will provide an analysis of the company's shareholder base and, based on that, help give strategic advice on the structure of the transaction. Following the commencement of the offer, the information agent will handle the distribution of tender offer documentation (if the transaction is structured as a self-tender) and will field telephone calls from shareholders with questions about the offer or procedures for tendering their shares.

Dealer Manager. The dealer manager (typically an investment banking firm retained by the company) will solicit tenders or consents and communicate generally regarding the

Practical Tip:
Key Players in a Going Private Transaction (Cont'd)



transaction with brokers, dealers, commercial banks and trust companies. In smaller deals, the information agent plays this role.

Depository. In a self-tender transaction, the depository, typically a company's transfer agent, receives tenders of shares and provides daily updates to the company on the number of shares tendered.

Outside Counsel. Outside counsel will prepare the transaction documents and handle filings and communications with the SEC. It will also advise the Board (and Special Committee if the Special Committee does not retain separate counsel) on the legal aspects of the transaction and on the fiduciary duties of the directors. The Special Committee may wish to retain independent counsel.

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Chapter 14

Foreign Private Issuers

Many companies that issue securities in the United States are based outside the United States. U.S. securities laws apply to these companies, but their U.S. reporting obligations vary widely. Non-U.S. companies may become subject to the SEC's periodic reporting requirements:

- If they have assets of over \$10 million and over 500 shareholders (of whom over 300 are in the U.S.);
- By issuing securities in the U.S. in an SEC-registered offering; or
- By listing securities on a national securities exchange (usually the NYSE or Nasdaq).

These non-U.S. reporting issuers can benefit from relief from several key SEC reporting requirements and securities exchange rules if they qualify as *foreign private issuers*. For non-U.S. reporting issuers that do not meet the very specific SEC definition of foreign private issuer, they generally must comply with U.S. securities laws as if they were based in the U.S. Some foreign private issuers voluntarily comply with the more demanding U.S.-company requirements.

What Is a Foreign Private Issuer?

A business based outside the U.S. with assets of over \$10 million and more than 500 worldwide shareholders (of whom over 300 are in the U.S.) will need to fully comply with U.S. securities laws – unless it fits the strict definition of a foreign private issuer. (In this context, *private* means a business, as opposed to a foreign government. It does not mean private in the sense of a U.S. company that has not issued shares to the public.) The

definition limits the true foreign private issuer to a company that is organized under the laws of a jurisdiction outside the United States and for which:

- *Non-U.S. shareholders:* At least half of its outstanding voting securities are owned, directly or indirectly, by non-U.S. residents; or
- *Based and Managed Outside the U.S.:* If it fails the non-U.S. resident ownership test, each of the following applies:
 - A majority of its directors and a majority of its executive officers are not U.S. citizens or residents;
 - Over half of its assets are located outside the U.S.; and
 - The business is not managed principally in the U.S.

If a company is able to show either that it has less than 50% U.S. ownership or, even if it has over 50% U.S. ownership, it is not located or managed in the U.S., or managed by U.S. personnel, then the entity will be a foreign private issuer, subject to less stringent reporting and governance requirements than U.S.-based companies.

A foreign private issuer is wholly exempt from the 1934 Act reporting requirements if it does not have a class of equity securities held directly or indirectly by at least 300 U.S. residents.

A foreign private issuer tests its continuing status as a foreign private issuer at least annually on the last business day of its second quarter. If it no longer meets the test, it generally must comply with U.S.-company registration and reporting obligations on the first day of its upcoming fiscal year.

<i>Are You a Foreign Private Issuer?</i>	
You have under \$10 million in assets or less than 500 shareholders (in total) or less than 300 U.S. shareholders.	No. Nor should you be subject to SEC public company reporting obligations.
You have over \$10 million in assets and over 500 shareholders (in total) and 300 shareholders in the U.S., and:	
50% or less of your voting securities are owned by U.S. residents.	Yes. You meet the foreign private issuer definition.

<p>Even if over 50% of your voting securities are owned by U.S. residents, none of these apply:</p> <ul style="list-style-type: none"> (a) A majority of neither your executive officers nor your directors are U.S. citizens or residents; (b) Over half your assets are located outside the U.S.; and (c) The business is not managed principally in the U.S. 	<p>Yes. You meet the foreign private issuer definition.</p>
<p>You have over \$10 million in assets and over 500 shareholders (in total) and 300 shareholders in the U.S., and you do not meet the foreign private issuer definition.</p>	<p>No. You must comply with SEC registration and periodic reporting requirements applicable to U.S. companies.</p>
<p>You choose to list your company with the NYSE or Nasdaq or other national securities exchange and you meet the foreign private issuer definition.</p>	<p>Yes. You are subject to SEC registration and reporting requirements and securities exchange rules, but qualify for the less stringent requirements.</p>
<p>You choose to list your company with the NYSE or Nasdaq or other national securities exchange but do not meet the foreign private issuer definition.</p>	<p>No. You must comply with SEC registration and periodic reporting requirements and securities exchange rules applicable to U.S. companies.</p>
<p>You choose to register an offering of securities under the 1933 Act and meet the foreign private issuer definition.</p>	<p>Yes. You are subject to SEC registration and reporting requirements, but qualify for the less stringent requirements.</p>
<p>You choose to register an offering of securities under the 1933 Act but do not meet the foreign private issuer definition.</p>	<p>No. You must comply with full periodic reporting and other obligations for a period of time mandated by SEC rules.</p>

Benefits of Being a Foreign Private Issuer: The Notable Nine

A foreign private issuer benefits from at least nine significant areas of relief from SEC reporting and governance obligations. This may be the case, as we have described, even if over 50% of its voting securities are owned by U.S. residents. Canadian foreign private issuers may separately be subject to home country requirements that limit the benefits otherwise generally available to foreign private issuers.

The nine principal benefits include:

1. *No Quarterly or Current Reports.* Foreign private issuers need not file quarterly reports on Form 10-Q (or otherwise) or file current reports on Form 8-K.
2. *Section 16 Reporting and Short-Swing Relief.* Insiders of foreign private issuers are not subject to 1934 Act Section 16(a) reporting of their securities transactions. In addition, Section 16(b)'s "short-swing" profit disgorgement requirements do not apply.
3. *SEC Proxy Rule Exemption.* The SEC's proxy statement disclosure requirements and proxy solicitation rules do not apply to foreign private issuers.
4. *Dodd-Frank Act Exemptions.* Several key corporate governance reforms of the Dodd-Frank Act do not apply to foreign private issuers, including those related to proxy statement matters such as Say-on-Pay and golden parachute disclosure and voting, disclosure relating to chair/CEO overlaps and performance-to-pay ratios, and the proposed proxy access rules.
5. *GAAP Flexibility.* In preparing its financial statements to be provided to the SEC, a foreign private issuer can choose among U.S. GAAP, non-U.S. GAAP (with a reconciliation to U.S. GAAP) or the International Financial Reporting Standards (IFRS).
6. *Reduced Executive Compensation Disclosure.* Foreign private issuers may provide significantly reduced executive compensation disclosure than U.S. companies, including in

most cases by providing aggregate rather than individual disclosure of executive compensation.

7. *No Accelerated Filing.* A foreign private issuer using a Form 20-F annual report need not file the report 60 days after fiscal year-end. Instead, for fiscal years ending on or after December 15, 2011, annual reports on Form 20-F are to be filed within four months after the end of the fiscal year.
8. *Exemption From Regulation FD.* Regulation FD expressly exempts foreign private issuers from its requirements. As a result, Regulation FD does not mandate foreign private issuers to make simultaneous or prompt public disclosure of material nonpublic information. However, many foreign private issuers comply with Regulation FD as a “best practice,” even though they are exempt! To do otherwise could be the basis for liability for violation of U.S. and foreign securities law – not under Regulation FD but of long-standing principles underlying the regulation.
9. *NYSE and Nasdaq Corporate Governance Exemptions.* Foreign private issuers listed on the NYSE or Nasdaq are generally exempt from most of the exchanges’ corporate governance rules, other than SEC Audit Committee requirements, to the extent not required by the issuer’s home country laws. The exemptions cover independence determinations, Compensation and Nominating & Governance Committees and other matters.

Practical Tip:
**Consider Market and Investor Wishes for Voluntary
Disclosure**



Even if your company could qualify for SEC and exchange accommodations as a foreign private issuer, you will want to carefully consider market and investor reactions. The benefit of reduced disclosure may be tempting but illusory for a company that depends heavily on the U.S. capital markets.



Practical Tip:
Consider Market and Investor Wishes for Voluntary Disclosure (Cont'd)

As a result, many foreign private issuers seek to minimize distinctions between themselves and domestic U.S. companies by voluntarily electing to use SEC Forms 10-K, 10-Q and 8-K. This typically is binding for at least one year. In spite of this election, the company may continue to make compensation disclosure as required by Form 20-F and to provide financial statements under non-U.S. GAAP (with a reconciliation to U.S. GAAP) or under IFRS.

Other foreign private issuers find other ways to provide information to the market that is similar in substance and timing to that of domestic companies. This can permit them to satisfy market demands while retaining disclosure flexibility. These foreign private issuers may elect to file annual reports on Form 20-F in advance of their due dates and to voluntarily file Form 6-Ks on a quarterly basis that include the quarterly information equivalent to a Form 10-Q. They may also provide proxy disclosure that is similar in many respects to that of domestic companies and, in deference to corporate governance concerns, conform with the NYSE and Nasdaq corporate governance requirements.

Foreign Private Issuers Under Sarbanes-Oxley

In many other ways, including reporting on internal controls, foreign private issuers have no advantage over U.S.-based companies. For example, CEOs and CFOs of foreign private issuers must file certifications with their annual reports filed with the SEC. And foreign private issuers are subject to Section 404 of Sarbanes-Oxley regarding management's internal control reports and independent auditor's attestations and reports in annual reports.

Breaking News: The Dodd-Frank Act



While most of the Dodd-Frank Act does not apply to foreign private issuers, follow the rulemaking for these provisions, which are likely to impact foreign private issuers:

- Beneficial ownership reporting;
- Compensation Committee independence;
- Pay ratio disclosures;
- Clawback policies for incentive-based compensation; and
- Overtime extension of U.S. and SEC jurisdiction outside the United States for actions brought under the antifraud provisions of the U.S. federal securities laws.

Foreign private issuers, carefully monitor the implementation of these provisions of the Dodd-Frank Act!

The Rule 12g3-2(b) Exemption

Rule 12g3-2(b) under the 1934 Act exempts foreign private issuers from any obligation to register a class of securities if the company and the applicable class of securities have a primary trading market outside the United States. To satisfy this exemption, the company must publish material investment information in English on its website. A foreign private issuer can take advantage of the Rule 12g3-2(b) registration exemption without submitting a written application to the SEC as long as it continues to meet these requirements.

Rule 12g3-2(b) is also available to a foreign private issuer that meets *each* of these three tests:

- The company maintains a listing of the subject class of securities on one or two exchanges in its *primary trading market* outside the U.S. (i.e., where at least 55% of worldwide trading took place during the last fiscal year and the trading in either of such exchanges exceeded trading in the security in the United States);

- The company is not otherwise subject to 1934 Act reporting obligations; and
- The company has published in English, from the first day of its most recent fiscal year, on its website or through an electronic information delivery system generally available to the public in its primary trading market, the information that the company has made public or distributed to its security holders, or is required to make public or distribute to its security holders, pursuant to its home country law or regulations of its principal securities market.

Practical Tip:

The Special Benefit of Reduced Disclosure for Unlisted ADR Programs With Reduced Disclosure Obligations



Foreign private issuers can use the Rule 12g3-2(b) exemption in establishing an *unlisted* American Depository Receipts (ADR) program.

Rather than issue equity shares directly to U.S. investors, foreign private issuers often offer ADRs in U.S. markets. Under an ADR program, a U.S. financial institution, called a *depository*, issues to investors (on behalf of the issuer) registered certificates, representing underlying foreign shares. The underlying foreign shares typically are held by a financial institution, called a *custodian*, in the home country of the issuer. The ADR program often provides benefits to the issuer and security holders. Benefits include avoiding inconvenient transfer procedures, dividend conversion into U.S. dollars from a foreign currency and certain taxes.

A foreign private issuer may seek to list the ADRs on a U.S. national securities exchange, which will trigger full 1934 Act reporting obligations for the issuer. Alternatively, the foreign private issuer may establish an unlisted ADR program by having the ADRs trade in the U.S. over-the-counter markets and qualifying for the Rule 12g3-2(b) exemption from 1934 Act reporting.

SEC 1934 Act Reporting and Disclosure Requirements

A foreign private issuer's primary 1934 Act disclosure obligations are to file an annual report with the SEC and to disclose certain material information by furnishing to the SEC any required reports on Form 6-K. Nearly all SEC disclosure is required to be in English. An issuer's failure to timely file an annual report will restrict the issuer's ability to use a Form F-3 or S-3 "short form" registration statement for offerings of its securities.

Annual Report: Form 40-F (for Canadians) or 20-F (for All Others)

Most foreign private issuers subject to reporting obligations under the 1934 Act file an annual report on Form 20-F rather than Form 10-K. Canadian companies meeting specific criteria may file on Form 40-F. Form 20-F falls due 120 days after the end of the fiscal year.

Trap for the Unwary: Financial Statement Date Requirements for Public Offerings May Require Early Filing of Statements



Audited financial statements of a foreign private issuer generally must be as of a date no more than 15 months prior to the effective date of a registration statement for a public offering of securities. Likewise, the SEC imposes a similar restriction on public offerings under a shelf registration statement. Accordingly, a foreign private issuer that waits until the end of the four-month Form 20-F filing deadline to file its audited annual financial statements will be unable to undertake a public offering of its securities during the period beginning three months after the fiscal year-end and ending on the date the audited financial statements are filed.

Canadian foreign private issuers may file their annual reports with the SEC on Form 40-F. This form is a wrap-around available only if the Canadian company meets three requirements:

- It must be a Canadian foreign private issuer;
- It needs to meet the market capitalization test of a US\$75 million float; and
- It must have been subject to review by Canadian securities regulators for at least 12 months.

The Form 40-F *wrap* includes:

- A cover page;
- Sarbanes-Oxley disclosure, including, among other things, management's internal control reports and the independent auditor's annual attestation report;
- The issuer's Canadian annual information form;
- Audited annual financial statements; and
- MD&A of financial condition and results of operations as prepared in compliance with Canadian requirements.

The Form 40-F is filed on the same date the annual information report is due to be filed in Canada.

Information Included in Form 20-F

Form 20-F is a more comprehensive stand-alone periodic report. Form 20-F generally requires disclosure similar to that under Form 10-K:

- *Company Description:* A description of the company's history, business, organizational structure and property, including any developments during the fiscal year.
- *Risk Factors:* A description of risk factors and any material legal proceedings.
- *MD&A.* Management's discussion and analysis of financial condition and results of operations, including information concerning the company's liquidity, current trends and off-balance sheet arrangements.

- *D&O Disclosures*. Information regarding the directors, managers and key employees, including background and compensation. Disclosure for executive officers and directors may be presented in the aggregate, not by individual.
- *5% Shareholders*. Information about more than 5% beneficial owners, transactions with related parties and security ownership.
- *Audited Financial Statements*. Financial statements audited by an independent auditor, and accompanied by an audit report, for the last three fiscal years. For the first filing with the SEC under the IFRS, only two fiscal years are needed.
- *Price Data*. Disclosure of the price history of the listed securities, as well as disclosure of all stock exchanges and other regulated markets on which securities are listed.
- *Charter*. Miscellaneous information concerning the company's governing charter documents (if not filed previously), material contracts, and exchange controls and taxation in the home country.
- *Internal Controls/404*. Disclosure of the effectiveness of disclosure controls and procedures as well as management's report on internal control over financial reporting and the related public accounting firm's attestation report.
- *Audit Committee Financial Expert*. Identification of the company's Audit Committee financial expert or experts.
- *Code of Ethics*. Whether the company has adopted a code of ethics for its principal executive officer, principal financial officer and principal accounting officer or controller.
- *CEO/CFO Certifications*. CEO and CFO certifications under Sarbanes-Oxley.



**Trap for the Unwary:
Keep in Mind the Particular Purpose of
Form 20-F**

Form 20-F serves dual functions. It can be used for a foreign private issuer's annual report. It can also be used to register a foreign private issuer's securities under the 1934 Act. Many disclosure requirements in Form 20-F only apply when the form is used for one of those two purposes. Be cautious to draft the disclosure for the specific purpose.



**Practical Tip:
Consider Providing Additional Compensation
Information**

Form 20-F includes two paragraphs of general disclosure requirements for compensation of executive officers and directors. This is drastically less than Item 402 of Regulation S-K, which is what causes proxy disclosure to go on for several pages and include detailed instructions and forms of tables. Form 20-F does *not* require disclosure about executive compensation *on an individual basis* unless it is required in the home country or is otherwise publicly disclosed by the foreign private issuer. Nor does it limit disclosure to the "named executive officers" for which domestic companies provide individual disclosure, or explicitly require Compensation Discussion and Analysis (CD&A) disclosure about the basis and methods of determining executive compensation. As a result, compensation information of foreign private issuers typically is not as detailed or comprehensive as for domestic companies.

However, executive compensation currently is a "hot topic" in the U.S. In light of this focus, some foreign private issuers voluntarily provide additional executive compensation information. For example, consider including a CD&A required of U.S. companies or, if not providing compensation disclosure for individual executives, providing additional aggregate disclosure for "named executive officers."

Reports on Form 6-K

Foreign private issuers “furnish” supplementary reports on Form 6-K. The timing and content of these reports is less demanding than are counterpart Forms 10-Q and 8-K for U.S. companies. In connection with public offerings, underwriters often insist that a foreign private issuer voluntarily furnish to the SEC Form 6-K quarterly reports. This provides investors with quarterly financial disclosure comparable to U.S. companies. As discussed below, the NYSE and Nasdaq require the filing on Form 6-K of one interim earnings release annually.

A foreign private issuer must “furnish” a Form 6-K to the SEC to disclose certain material information that the foreign private issuer:

- Makes public in accordance with the laws of its home country;
- Files with any exchange on which its securities are traded and which information the exchange makes public; or
- Distributes or is required to distribute to its security holders.

This is a quite short list for required use of a Form 6-K. The Form 6-K instructions provide examples of material events that may need to be disclosed, which are similar to many of the events that require U.S. companies to file a current report on Form 8-K.

If required to be furnished, the report on Form 6-K must be provided to the SEC “promptly” after the information contained in it is made public to the issuer’s security holders by the issuer, by the applicable securities exchange or pursuant to the laws of the issuer’s home country.



**Practical Tip:
Furnished, Not Filed - Means No “Incorporation by
Reference”**

Unless otherwise stated therein, a foreign private issuer “furnishes” a Form 6-K to the SEC. As such, there is no automatic “incorporation by reference” into any 1933 Act registration statements (e.g., a Form F-3 or S-8). However, an issuer may expressly state in the Form 6-K that it is to be deemed filed and incorporated by reference into specified registration statements. For example, an issuer that files quarterly Form 6-Ks may do this to provide updated disclosure for a shelf registration statement or a registration statement relating to an incentive equity plan.

Other Ongoing SEC Filing and Disclosure Requirements

Holdings of 5% or more of applicable securities of a foreign private issuer must file with the SEC statements of beneficial ownership on Schedule 13D or 13G. (We discuss Schedules 13D and 13G in Chapter 4.)



**Breaking News:
Foreign Private Issuers and XBRL**

In April 2011, the SEC issued a no-action letter specifying that foreign private issuers that prepare their financial statements in accordance with IFRS, unlike U.S. companies and excluding foreign private issuers that prepare their statements under U.S. GAAP, are not required to post on their websites or file any interactive data files (XBRL). This may change, as it applies only until the SEC specifies taxonomy to use in preparing the relevant interactive data files.

The NYSE and Nasdaq Exchange Requirements

A public company generally must register its securities, including ADRs if applicable, under the 1934 Act before it may list the securities on a U.S. national securities exchange. The company must also qualify and apply for listing with the exchange. Foreign private issuers may qualify for listing on the NYSE under U.S. domestic listing standards or alternative listing standards for non-U.S. issuers. The NYSE and Nasdaq listing standards include quantitative and qualitative standards, including ongoing standards for continued listing.

Corporate Governance Standards

Foreign private issuers listed on the NYSE or Nasdaq are generally exempt from most of the exchange's corporate governance rules to the extent compliance with those rules is not required by the issuer's home country laws. However, the NYSE and Nasdaq generally require the foreign private issuer to disclose the significant differences in its corporate governance practices from those practices required of U.S. companies under the exchange's corporate governance rules. This can be a brief general summary of any significant differences, included in annual reports on Form 20-F. Foreign private issuers not using Form 20-F may include the "significant difference" disclosure on their websites in English or in their annual reports to shareholders.

Neither the NYSE nor Nasdaq exempts foreign private issuers from rules governing the composition and independence of Audit Committees. In addition, the NYSE requires that the foreign private issuer or its CEO provide NYSE annual and interim certifications and affirmations as to compliance with NYSE corporate governance rules.

If a company ceases to qualify as a foreign private issuer, the NYSE generally provides a six-month transition period. This allows the company to comply with NYSE standards requiring a majority of independent directors, independent Compensation and Nominating & Governance Committees, and website posting of Committee charters, corporate governance guidelines and a Code of Business Conduct and Ethics. The transition period begins on the last business day of the second quarter of the company's fiscal year, the date that companies annually determine their foreign private

issuer status. The NYSE generally will permit a company that no longer qualifies as a foreign private issuer to temporarily continue to issue awards under equity compensation plans that have not been approved by shareholders. (This transition period generally ends on the later of six months after the date the company determines it no longer qualifies as a foreign private issuer and the first annual meeting after that date, but in no event more than one year after the determination date.)

Other, Noncorporate Governance Requirements

Foreign private issuers are subject to many other exchange rules and policies, most of which are also applicable to U.S. companies. Rules and policies with particular application to foreign private issuers include:

- Nasdaq rules and NYSE policy provide for the foreign private issuer to issue an earnings release covering the first half of its fiscal year and submit it to the SEC under Form 6-K. Under Nasdaq rules, Form 6-K includes an interim balance sheet and an income statement.
- The NYSE provides that the issuer must make an English language version of its annual report available on its website.
- The company's website should also describe (in English) the location of documents required to be posted.

Deregistration

A foreign private issuer may seek to terminate its registration of securities under the 1934 Act and related reporting obligations by filing a Form 15F with the SEC. When the issuer files the Form 15F, all reporting obligations are temporarily suspended until either the issuer's request becomes effective, because it is approved or the 90-day waiting period ends, or the SEC rejects the request. To be eligible to file a Form 15F, a foreign private issuer generally must meet certain requirements relating to the trading activity of its securities in the United States relative to worldwide trading, the issuer's 1934 Act reporting compliance, issuance of registered securities in the United States and listings on non-U.S. exchanges during the prior 12 months. In some cases, the foreign private issuer may need to wait 12 months following delisting of the securities from a U.S. securities exchange before deregistering the securities under the 1934 Act.

Appendix 1

Annual 1934 Act Reporting Calendar (SEC Reporting and Annual Shareholders' Meeting)

The following sample form of Annual 1934 Act Reporting Calendar for SEC Reporting and Annual Shareholders' Meeting purposes provides a starting point for creating your company's checklist and timetable for the tasks associated with SEC periodic reporting obligations and the annual shareholders' meeting. Tailor the Calendar to reflect your company's specific requirements and timing. Work closely with your company's internal reporting teams (legal, finance, investor relations, human resources, etc.), Disclosure Practices Committee, outside legal counsel and independent auditors to ensure compliance with each of: (a) the 1934 Act requirements and other federal securities law requirements; (b) state law requirements (the Calendar assumes a company incorporated in Delaware); (c) the company's charter, bylaws, reporting and governance policies and Board committee charters; and (d) applicable NYSE or Nasdaq listing standards. For simplicity, the Calendar assumes that your company is a U.S. company and a large accelerated filer with a December 31 fiscal year-end and a May 15 annual meeting date, that no proposal to be considered at the annual meeting will require the filing of a preliminary proxy statement with the SEC, and that earnings releases are released and quarterly reports are filed generally around the same time.

Date*	Item	Responsibility
December 1	Schedule insider trading "blackout" periods for upcoming year <i>(Generally begins two to four weeks prior to quarter end, and will end after the second full business day following company's earnings release for that quarter, although timing will depend on company policy)</i>	<i>Company</i>
	Schedule reminders to be sent to officers and directors on the first day of every month to remind them to give prior notice to and obtain preclearance from company with respect to securities transactions to be made during that month at least two business days prior to a transaction <i>(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)</i>	<i>Company</i>
December 1 – 6	Coordinate with auditors regarding Q4 and year-end audit	<i>Company/Auditors</i>

** Dates will change depending on the calendar year. Generally, if the last filing day relating to an SEC filing requirement falls on a weekend or holiday, then the last filing day relating to such filing shall extend to the next business day.*

Date*	Item	Responsibility
December 1 – 9	Meetings of internal reporting teams, including meeting of Disclosure Practices Committee regarding, among other things: planning for Q4 and year-end earnings release; 10-K and proxy season reporting; disclosure/materiality issues relating to public disclosures; review of disclosure controls and procedures and internal control over financial reporting; and CEO/CFO certifications for 10-K	<i>Company</i>
December 1 – 10	Schedule appropriate meetings for actions to be taken by Audit, Compensation, Nominating & Governance, and other Board Committees, and Disclosure Practices Committee and other management committees for upcoming year	<i>Company</i>
December 5 – 9	Determine whether company or any intermediaries will use SEC “householding” rules regarding delivery of annual meeting materials	<i>Company/ Legal Counsel</i>
December 5 – 16	Review FD policy, provide training sessions for applicable personnel and confirm a response team is prepared to act upon unintentional disclosures	<i>Company</i>
December 19 – 23	Determine if preliminary proxy statement will be required; if so, revise schedule accordingly, including accelerating initial filing of proxy statement	<i>Company/Legal Counsel</i>
	Determine whether company will elect to use “notice only” or “full set delivery” proxy solicitation model, or a combination of both, and revise schedule accordingly <i>(Companies using the notice only option must post proxy materials on website and send Notice of Internet Availability at least 40 calendar days before the date of the annual meeting, and some intermediaries have indicated that they require companies to furnish information required for Notice of Internet Availability at least 47 calendar days before the date of the annual meeting)</i>	<i>Company/Legal Counsel</i>
December 23 – 26	Determine if paper and envelopes should be ordered for proxy materials and annual report to shareholders <i>(Particularly if a large printing of a glossy annual report to shareholders will be required)</i>	<i>Company</i>

Date*	Item	Responsibility
	Determine printing and mailing logistics for the Notice of Internet Availability <i>(Notice must be sent in paper to each shareholder and beneficial owner unless affirmative consent to electronic delivery has previously been given)</i>	<i>Company</i>
	Select provider for web hosting of proxy materials	<i>Company</i>
	Confirm whether company is a “large accelerated filer” or “accelerated filer” under SEC rules and revise schedule if needed (<i>See Chapter 2 of The Public Company Handbook</i>)	<i>Company</i>
	Determine whether a proxy solicitor will be used	<i>Company</i>
	Select printer(s) for proxy materials, 10-K and annual report to shareholders (as well as determine if annual report to shareholders will have special graphics or photography)	<i>Company</i>
December 26 – 30	Distribute D&O Questionnaires (including Audit Committee financial expert/independence materials) relating to annual proxy statement, 10-K and Form 5s	<i>Company/Legal Counsel</i>
December 31	End of Q4 and reporting year	
January 2 – 4	Planning meeting to review and update business section, MD&A and risk factors in 10-K	<i>Company/Legal Counsel/Auditors</i>
	Determine record date, agenda, location, time and date of annual meeting	<i>Company</i>
January 3 – 10	Begin closing books and compiling information for financial statements and notes for Q4 and year-end; continue coordinating with auditors regarding Q4 and year-end audit; draft financial statements and notes for Q4 and year-end; draft Q4 earnings release	<i>Company/Auditors</i>
January 5 – 23	Draft 10-K, including financial statements and notes	<i>Company</i>
	In connection with XBRL reporting requirements: <ul style="list-style-type: none"> • If self-tagging data in XBRL, begin selecting or extending taxonomy, then map each line item to the correct XBRL element • If not self-tagging, contact third-party service provider to determine date on which financial statements must be submitted for tagging 	<i>Company</i>

Date*	Item	Responsibility
January 8 – 15 <i>(assuming company will file its definitive annual proxy materials between March 29 and April 5)</i>	Final date company may file with SEC no-action requests regarding shareholder proposals for annual proxy statement <i>(Rule 14a-8 under the 1934 Act requires filing no-action requests no later than 80 calendar days prior to filing of definitive proxy materials with SEC)</i>	Company/Legal Counsel
January 9 – 11	Schedule quarterly notifications to be provided to insiders regarding the opening of the insider trading windows <i>(Generally notify insiders two or three weeks before quarterly earnings release, although timing will depend on company policy)</i>	Company
January 10 – 24	Prepare first draft of annual proxy statement, proxy card and notice	Company
	Prepare first draft of Audit Committee Report <i>(Circulate to Audit Committee for review and revision at next Audit Committee meeting)</i>	Company
	Confirm “Named Executive Officers” for proxy statement	Company
	Prepare first draft of Compensation Discussion & Analysis (CD&A), compensation tables and Compensation Committee Report <i>(Circulate to Compensation Committee for review and revision at next Compensation Committee meeting)</i>	Company
	Determine drafter of performance graph for annual report to shareholders, as necessary <i>(Often outside consultant will draft the performance graph with assistance from investor relations department)</i>	Company
January 11	Completed D&O Questionnaires, Section 16 reporting certifications and information relating to Form 5s due back to company	Company
January 11 – 16	Auditors review Q4 and year-end financial statements; auditors confirm numbers for Q4 earnings release	Auditors
	Draft and distribute Q4 earnings release to legal counsel for review	Company

Date*	Item	Responsibility
<p>January 15 <i>assuming prior year's annual meeting was held on May 15 and company's bylaws' advance notice provision provides that shareholder nominations and other proposals must be made no earlier than 120 days prior to the anniversary of the prior year's annual meeting date. .</i> <i>Note: company's bylaws may provide for different period)</i></p>	<p>First date for receipt of shareholder's director nominations and other shareholder proposals that may be brought before annual meeting if not otherwise included in company's proxy statement pursuant to Rule 14a-8 under the 1934 Act</p>	<p><i>Company/Legal Counsel</i></p>
<p>January 16 – 17</p>	<p>Disclosure Practices Committee Meeting regarding issues relating to Q4 earnings release and year-end financial results, evaluation of disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-K, and CEO/CFO certifications</p>	<p><i>Company</i></p>
<p>January 18</p>	<p>Distribute Board and Committee materials for January 23 – 24 meetings, including Q4 earnings release and Q4 and year-end financial results</p>	<p><i>Company</i></p>
<p>January 23 – 24</p>	<p>Nominating & Governance Committee Meeting regarding review and recommendation of slate of director nominees (and may review director independence and any related party transactions depending on company's review policies)</p>	<p><i>Company</i></p>

Date*	Item	Responsibility
	<p>Audit Committee Meeting to:</p> <ul style="list-style-type: none"> • Review Q4 and year-end financial results, including Q4 earnings release • Review auditors' relationship with company, including the lead partner's performance • Review auditors' annual report on its internal quality control procedures, including any issues raised through its internal review, and the assessment of auditors' independence • Appoint independent auditors (including review and applicable preapproval and approval of services and fees and such policies) • Review Disclosure Practices Committee report relating to Q4 and year-end financial results • Review financial expertise, financial literacy and independence of Audit Committee members • Review auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter <p><i>(Meeting should be prior to Q4 earnings release with ample time following meeting for legal and accounting review of any revisions to release)</i></p>	Company
	<p>Board Meeting approving, among other things:</p> <ul style="list-style-type: none"> • Annual meeting date, time, location and record date • Business to be transacted at annual meeting • Inspectors of election with power of substitution • Independence determinations of directors • Officers to vote proxies with full power of substitution • Authorization for the preparation and distribution to shareholders of a notice of meeting, proxy card, proxy statement, annual report to shareholders, 10-K and other materials as may be appropriate • Determination of slate of director nominees and recommendation of slate to shareholders (including any shareholder nominations) <p><i>(Notify applicable exchange of annual meeting and record dates per exchange requirements)</i></p>	Company
January 24	Distribute complete 10-K and proxy statement and related materials to legal counsel and auditors for initial review	Company
	<p>Release Q4 and year-end numbers in earnings release; conference call regarding Q4 and year-end financial results</p> <p><i>(Make applicable financial information available on website and applicable report filing with SEC; send required number of copies of earnings release materials to applicable exchange)</i></p>	Company

Date*	Item	Responsibility
January 30	Initial comments due back to company from legal counsel and auditors on complete 10-K and proxy statement and related materials, including Compensation Committee and Audit Committee Reports	<i>Legal Counsel/ Auditors</i>
February 1 – 6	Senior management initial review of 10-K and proxy statement and related materials <i>(Start tracking all changes)</i>	<i>Company</i>
February 1 – 7	Prepare Board resolutions relating to annual meeting and reporting actions (if not done at January meeting) for February 23 – 24 Board meeting, together with related Board Committee resolutions	<i>Company/Legal Counsel</i>
February 6 – 10	Revise 10-K and proxy statement and related materials, including Compensation Committee and Audit Committee Reports	<i>Company</i>
February 10	Distribute revised 10-K and proxy statement and related materials per management's review to legal counsel and auditors for review	<i>Company</i>
February 14	Comments due back to company from legal counsel and auditors on 10-K and proxy statement and related materials, including Compensation Committee and Audit Committee Reports	<i>Legal Counsel/ Auditors</i>
	Form 5s due at SEC regarding securities transactions made in prior reporting year relating to securities transactions not disclosed in Form 4 filings for prior reporting year <i>(Required to be filed with SEC on or before the 45th day following the end of the reporting year)</i>	<i>Company/Legal Counsel</i>
	Deadline for eligible shareholders to file reports or amendments on Schedule 13G <i>(Required to be filed with SEC on or before the 45th day following the end of the reporting year)</i>	<i>Shareholders</i>
	Communicate with transfer agent, proxy solicitor if engaged and printer regarding: <ul style="list-style-type: none"> • Proxy solicitation timetable • Record date • Annual meeting date • Annual proxy statement and related materials • Name and address of financial printer • Request for shareholder lists as of the record date • Instructions as to ordering and printing of mailing and return envelopes and proxy cards 	<i>Company</i>

Date*	Item	Responsibility
	<ul style="list-style-type: none"> • Confirmation of availability of post office box for return of proxies, if applicable • Electronic voting, if applicable, and dedicated website for e-proxy 	Company
February 14 – 16	<p>Communicate with banks, brokerage processing servicer and the Depository Trust Company (DTC), informing them of record date and the annual meeting date</p> <p><i>(SEC regulations require that these communications be done at least 20 business days prior to the record date)</i></p>	Company
<p>February 14 <i>(assuming prior year's annual meeting was held on May 15 and company's bylaws' advance notice provision provides that shareholder nominations and other proposals must be made no later than 90 days prior to the anniversary of the prior year's annual meeting date. Note: company's bylaws may provide for different period)</i></p>	<p>Final date for receipt of shareholder's director nominations or other shareholder proposals that may be brought before annual meeting if not otherwise included in company's proxy statement pursuant to Rule 14a-8 under the 1934 Act</p>	Company
February 15 – 16	<p>Disclosure Practices Committee Meeting regarding review of, and issues relating to, 10-K and proxy statement and disclosure controls and procedures and internal control over financial reporting, and conducting follow-up Q&A with business unit managers and other employees, relating to 10-K and proxy statement, and CEO/CFO certifications</p>	Company
February 16	<p>Hold diligence session regarding CEO/CFO certifications for 10-K and management's report on internal control over financial reporting to, among other things, review Disclosure Practices Committee report and review disclosure controls and procedures and internal control over financial reporting</p>	Company

Date*	Item	Responsibility
February 17	Distribute proxy materials (at least information incorporated by reference into 10-K) and substantially final draft of 10-K and annual report to shareholders (and in case of Board and Committees, other relevant Board and Committee materials) to Board, Committees, key senior management, legal counsel and auditors for review	<i>Company/Legal Counsel/Auditors</i>
	Send 10-K to printer	<i>Company/Printer</i>
February 21 – 27	Finalize 10-K	<i>Company/Legal Counsel/Auditors</i>
February 22 – 23	Obtain CEO and CFO certifications and applicable subcertifications for 10-K	<i>Company</i>
February 23 – 24	Nominating & Governance Committee Meeting to: <ul style="list-style-type: none"> • Recommend Committee assignments • Review Committee charter and recommend any charter changes to Board • Review Board and Committee compensation for recommendation to Board 	<i>Company</i>
	Compensation Committee Meeting to: <ul style="list-style-type: none"> • Approve Compensation Committee Report and CD&A for inclusion in the annual proxy statement • Review Committee charter and recommend any charter changes to Board 	<i>Company</i>
	Audit Committee Meeting to: <ul style="list-style-type: none"> • Review final audited financial statements with company and auditors, and recommend audited financial statements for inclusion in 10-K, and review other applicable parts of 10-K, including MD&A • Review and approve Audit Committee Report for proxy statement • Review auditors' and management's reports and discuss issues relating to disclosure and internal control over financial reporting • Review Committee charter and recommend any charter changes to Board • Recommend financial expert(s) • Review audit fees to be listed in the proxy statement • Review auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>

Date*	Item	Responsibility
	<p>Board Meeting to, among other things, and as necessary:</p> <ul style="list-style-type: none"> • Approve proxy materials, annual report to shareholders and 10-K in substantially the form presented to Board • Appoint Committee members • Approve Board and Committee compensation • Appoint financial expert(s) • Review Audit Committee and Compensation Committee Reports for proxy statement • Approve any changes to Committee charters • Approve other actions relating to annual meeting, Board and Committees and annual reporting not previously approved • Review any reports from Audit Committee, including any reports regarding financial reporting and internal control over financial reporting 	Company
	Obtain signature pages and powers of attorney from Board members for 10-K	Company
February 27 – 28	Obtain executed report for audited financial statements and consents from auditors for filing as an exhibit to 10-K, including auditors' attestation report on management's report on internal control over financial reporting	Company/Auditors
February 27 – March 6	<p>Company must provide shareholders whose Rule 14a-8 shareholder proposals will be accompanied by a Board Opposition Statement in annual proxy statement with a copy of the Board Opposition Statement</p> <p><i>(Generally must be sent to applicable shareholders 30 calendar days prior to distribution of definitive annual proxy materials)</i></p>	Company/Legal Counsel
February 28 – March 1	<p>File 10-K with SEC</p> <p><i>(SEC regulations require that large accelerated filers file 10-K with SEC via EDGAR within 60 days of end of reporting year; accelerated filers are required to file 10-K within 75 days after end of reporting year; all other registrants are required to file 10-K within 90 days after end of reporting year. See Chapter 2 of The Public Company Handbook)</i></p>	Company

Date*	Item	Responsibility
	In connection with XBRL reporting requirements: <ul style="list-style-type: none"> • File the XBRL file as Exhibit 101 to 10-K at the time 10-K is filed with SEC • Post the XBRL file on company's website by the end of the calendar day in which the XBRL exhibit has been submitted to SEC or was required to be submitted, whichever is earlier <i>(SEC regulations require (1) posting of the XBRL file itself and not merely a link to the XBRL exhibit on SEC's website and (2) posting of the XBRL file on company's website for 12 months)</i>	<i>Company</i>
March 6 – 8	Prepare meeting admission guidelines and assign annual meeting responsibilities for: <ul style="list-style-type: none"> • Hosts (to direct seating, distribute and collect ballots) • Welcoming committee (officers assigned to greet shareholders and guests) • Arbiters (legal counsel or corporate secretary's staff who will handle difficult questions or complicated situations with regard to admission to the meeting) • Coordinating physical layout, security, audio/visual arrangements and webcast of the meeting, if applicable 	<i>Company</i>
March 6 – 16	Finalize annual proxy statement and related materials	<i>Company/Legal Counsel/Auditors</i>
March 10	If company has not already done so, notify applicable exchange of annual meeting date and record date pursuant to applicable exchange requirements <i>(Generally must be done at least 10 business days prior to record date)</i>	<i>Company</i>
	Deliver draft of proxy card to website host and transfer agent; work with website host on draft Notice of Internet Availability	<i>Company/Legal Counsel</i>
March 17 – 18	Send annual proxy statement and related materials, including proxy card, to printer	<i>Company/Legal Counsel/Printer</i>
	Send annual report to shareholders (or 10-K wrap) to printer <i>(This often may be done earlier depending on formatting/substance of annual report to shareholders)</i>	<i>Company/Printer</i>

Date*	Item	Responsibility
March 18 – 24	Blueine of annual proxy statement and related materials, including proxy card, to be reviewed and comments sent to printer; finalize annual proxy statement and related materials, including proxy card	<i>Company/Legal Counsel</i>
	Blueine of complete annual report to shareholders delivered for review	<i>Company/Legal Counsel/Printer</i>
	Transfer agent ships preaddressed proxy cards to printer	<i>Company/Transfer Agent</i>
March 24 – 29	Printer sends printed annual proxy materials and annual report to shareholders to transfer agent	<i>Company/Printer/Transfer Agent</i>
	Send required information to intermediaries for preparation of Notice of Internet Availability and posting of proxy materials on website <i>(If company elects notice only model, some intermediaries have indicated that they require companies to furnish information required for Notice of Internet Availability at least 47 calendar days before the date of the annual meeting)</i>	<i>Company</i>
March 26	RECORD DATE <i>(Depending on company bylaws and state law, generally set between 10 days and 60 days prior to the annual meeting date)</i>	<i>Company</i>
	Ask transfer agent to confirm number of voting shares and supply certified list of record date shareholders	<i>Company/Transfer Agent</i>
March 29 – April 5	File definitive proxy materials with, and send copies of annual report to shareholders to, SEC <i>(Copies of the definitive proxy statement, proxy card, Notice of Internet Availability and any other solicitation materials must be filed with SEC via EDGAR no later than the date such materials are first sent to shareholders. If company elects to use the notice only model, the proxy materials must be filed at least 40 calendar days before the date of the annual meeting. Send required number of copies to applicable exchange)</i>	<i>Company/Legal Counsel /Printer</i>

Date*	Item	Responsibility
	<i>(Eight hard copies of the annual report to shareholders must be mailed to SEC no later than the date on which the report is first sent or given to shareholders or the date on which preliminary copies (or definitive copies, if preliminary filing was not required) of the proxy materials are filed with SEC pursuant to Rule 14a-6(a), whichever date is later. Send required number of copies to applicable exchange)</i>	Company/Legal Counsel /Printer
	Send Notice of Internet Availability to shareholders concurrently with or after posting the proxy materials on website <i>(If company elects to use the notice only model, the notice must be sent at least 40 calendar days before the date of the annual meeting) (Notice must be sent in paper form unless shareholders have given affirmative consent to electronic delivery)</i>	Company
	If company elects to use full set delivery model, mail annual proxy statement and related materials, including proxy card, to all shareholders; each annual proxy statement must be accompanied or preceded by an annual report to shareholders, which needs to include audited financial statements <i>(Depending on state law and company bylaws generally, written notice of the annual meeting must be given not less than 10 nor more than 60 days before the date of the meeting to each shareholder entitled to vote at such meeting. Mailing must occur at least 20 to 30 days before annual meeting to timely receive brokers' votes)</i>	Company/Transfer Agent
	Post proxy materials on company website at or prior to the time company first sends the Notice of Internet Availability to shareholders <i>(References to a "company website" include a third-party website that complies with SEC rules. Note that SEC rules prohibit use of the SEC EDGAR website to satisfy website posting requirements)</i>	Company
	Distribute proxy statement and annual report to option holders and other applicable benefit plan participants	Company/Transfer Agent
	If elect notice only model, send copies of proxy materials to record holders and beneficial owners upon request <i>(Until the date of the annual meeting, copies requested must be sent within three business days of the shareholder request via first class mail or equivalent)</i>	Company
March 31	End of Q1	

Date*	Item	Responsibility
April 3 – 7	Meetings of internal reporting teams, including Disclosure Practices Committee, regarding Q1 financial statements, 10-Q, disclosure controls and procedures and internal control over financial reporting and CEO/CFO certifications for 10-Q	<i>Company</i>
April 7 – 19	Draft and review 10-Q, including financial statements and notes; coordinate with auditors regarding financial statements	<i>Company/Auditors</i>
April 10 – 14	Complete annual meeting arrangements for preparation of: <ul style="list-style-type: none"> • Ballots • Programs • Agenda • Meeting script • Q&A book • Inspectors' reports 	<i>Company/Legal Counsel</i>
April 12 – May 1	Prepare and submit periodic reports on proxy returns to management; determine if another proxy mailing is required	<i>Company/Transfer Agent/Proxy Solicitor</i>
April 14 – 19	Draft Q1 earnings release	<i>Company</i>
April 19	Distribute draft 10-Q, including financial statements and notes, and Q1 earnings release, to legal counsel and auditors	<i>Company</i>
April 19 – 24	Legal counsel and auditors review and provide comments on 10-Q and Q1 earnings release	<i>Legal Counsel/Auditors</i>
April 22 – 26	Review annual meeting script, speeches, audio/visual requirements, microphone requirements, catering arrangements, displays, parking requirements, security, procedure for checking in shareholders, coordination with news media and analysts and mechanics for webcast of the meeting, if applicable	<i>Company/Legal Counsel</i>
April 25	Comments due back on draft 10-Q, including financial statements and notes, and draft Q1 earnings release from legal counsel and auditors	<i>Legal Counsel/Auditors</i>
April 25 – May 1	If desirable, begin contacting by telephone those major shareholders who have not responded to proxy solicitation	<i>Company/Transfer Agent</i>

Date*	Item	Responsibility
	Confirm attendance of legal counsel and auditors at annual meeting	<i>Company</i>
April 25 – May 2	Revise Q1 financial statements, 10-Q and Q1 earnings release	<i>Company/Legal Counsel/Auditors</i>
April 28	Disclosure Practices Committee Meeting regarding issues relating to Q1 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-Q, and CEO/CFO certifications	<i>Company</i>
April 30	Deadline for filing proxy materials with SEC if 10-K incorporates information by reference from the proxy materials; file amendment to 10-K on 10-K/A if proxy statement is not filed by this date	<i>Company</i>
May 2	Distribute Q1 financial statements, 10-Q, Q1 earnings release and other materials to Audit Committee	<i>Company</i>
May 3 – 4	Hold CEO/CFO 10-Q certifications diligence session with Disclosure Practices Committee to review 10-Q, review disclosure controls and procedures and internal control over financial reporting and obtain CEO and CFO certifications and applicable subcertifications for 10-Q	<i>Company</i>
	Prepare script and management for earnings release conference call	<i>Company</i>
May 4	Have shareholder list open for examination <i>(The officer (usually the corporate secretary) in charge of the stock ledger must prepare and make available, at least 10 days before every annual meeting, a complete list of the shareholders entitled to vote at such meeting. Such list must be open to examination by any shareholder at the meeting place and, during ordinary business hours, for at least 10 days prior to the meeting at corporate headquarters. It must also be produced and kept at the time and place of the meeting during the whole time thereof. The specifics and availability will depend on company bylaws and state law requirements)</i>	<i>Company/Transfer Agent</i>
May 8	Audit Committee Meeting to: <ul style="list-style-type: none"> • Review Q1 financial results, including the earnings release • Review 10-Q 	<i>Company</i>

Date*	Item	Responsibility
	<ul style="list-style-type: none"> • Review Disclosure Practices Committee report relating to Q1 • Review auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>
May 8 – 10	Release Q1 numbers in earnings release; conference call regarding Q1 financial results <i>(Make applicable financial information available on website and applicable report filing with SEC; send required number of copies of press release materials to applicable exchange)</i>	<i>Company</i>
	File 10-Q for Q1 with SEC	<i>Company</i>
	In connection with XBRL reporting requirements: <ul style="list-style-type: none"> • File the XBRL file as Exhibit 101 to 10-Q at the time 10-Q is filed with SEC • Post the XBRL file on company's website by the end of the calendar day in which the XBRL exhibit has been submitted to SEC or was required to be submitted, whichever is earlier 	<i>Company/Printer</i>
May 13 – 14	Review meeting admission guidelines, "disruptive person" guidelines, proxy acceptance guidelines and any other applicable guidelines for annual meeting	<i>Company/Legal Counsel</i>
	Senior management briefing regarding annual meeting	<i>Company</i>
	Final revisions to management reports to be made at annual meeting and any accompanying presentations	<i>Company</i>
	Set up annual meeting headquarters at meeting site; rehearsals and final briefings	<i>Company</i>
May 14 – 16	ANNUAL MEETING OF BOARD AND BOARD COMMITTEE MEETINGS	<i>Company</i>
May 15	ANNUAL MEETING OF SHAREHOLDERS <i>(Notify applicable exchange of any changes in directors or executive officers as required)</i>	<i>Company</i>
	Complete Oath of Inspector of Election	<i>Company/Inspector of Election</i>

Date*	Item	Responsibility
May 16 – 19	Obtain final shareholder voting numbers in order to disclose results of annual meeting of shareholders on Item 5.07 of 8-K <i>(Information required to be filed within four business days after the end of the annual meeting; if annual meeting includes a Say-on-Frequency vote, company must file an amendment to the previously filed 8-K disclosing, in light of the Say-on-Frequency vote, company's decision on how frequently it will hold Say-on-Pay votes no later than 150 calendar days after the date of the annual meeting, but in no event later than 60 calendar days prior to the deadline for the submission of a Rule 14a-8 shareholder proposal for the subsequent annual meeting)</i>	<i>Company/Legal Counsel</i>
May 17 – 24	If applicable, send to exchange any required certifications or affirmations consistent with applicable exchange rules <i>(NYSE rules require the submission of a CEO Written Affirmation within 30 days of annual meeting)</i>	<i>Company</i>
June 30	End of Q2	
July 3 – 7	Meetings of internal reporting teams regarding Q2 financial statements, 10-Q, disclosure controls and procedures and internal control over financial reporting and CEO/CFO certification for 10-Q	<i>Company</i>
July 7 – 19	Draft and review 10-Q, including financial statements and notes; coordinate with auditors regarding financial statements	<i>Company/Auditors</i>
July 14 – 19	Draft Q2 earnings release	<i>Company</i>
July 19	Distribute 10-Q, including financial statements and notes, and Q2 earnings release to legal counsel and auditors	<i>Company</i>
July 19 – 24	Legal counsel and auditors review and provide comments on 10-Q and Q2 earnings release	<i>Legal Counsel/Auditors</i>
July 20	Board Meeting	<i>Company</i>
July 25	Comments due back on 10-Q, including financial statements and notes, and Q2 earnings release from legal counsel and auditors	<i>Legal Counsel/Auditors</i>
July 25 – August 1	Revise Q2 financial statements, 10-Q and Q2 earnings release	<i>Company/Legal Counsel/Auditors</i>

Date*	Item	Responsibility
July 28	Disclosure Practices Committee Meeting regarding issues relating to Q2 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-Q and CEO/CFO certifications	<i>Company</i>
	Distribute Q2 financial statements, 10-Q, Q2 earnings release and other materials to Audit Committee	<i>Company</i>
August 2 – 3	Hold CEO/CFO 10-Q certifications diligence session with Disclosure Practices Committee to review 10-Q, review disclosure controls and procedures and internal control over financial reporting and obtain CEO and CFO certifications and applicable subcertifications for 10-Q	<i>Company</i>
	Prepare script and management for Q2 earnings release conference call	<i>Company</i>
August 8	Audit Committee Meeting to: <ul style="list-style-type: none"> • Review Q2 financial results, including the earnings release • Review 10-Q • Review Disclosure Practices Committee report relating to Q2 • Review auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>
August 8 – 10	Release Q2 numbers in earnings release; conference call regarding Q2 financial results <i>(Make applicable financial information available on website and applicable report filing with SEC; send required number of copies of press release materials to applicable exchange)</i>	<i>Company</i>
	File 10-Q for Q2 with SEC (including, if necessary, notice requirements regarding shareholder proposals for next year's proxy)	<i>Company</i>
	In connection with XBRL reporting requirements: <ul style="list-style-type: none"> • File the XBRL file as Exhibit 101 to 10-Q at the time 10-Q is filed with SEC • Post the XBRL file on company's website by the end of the calendar day in which the XBRL exhibit has been submitted to SEC or was required to be submitted, whichever is earlier 	<i>Company</i>

Date*	Item	Responsibility
September 20	Board Meeting and Committee Meetings	<i>Company</i>
September 30	End of Q3	
October 2 – 6	Meetings of internal reporting teams regarding Q3 financial statements, 10-Q, disclosure controls and procedures and internal control over financial reporting and CEO/CFO certification for 10-Q	<i>Company</i>
October 6 – 18	Draft and review 10-Q, including financial statements and notes; coordinate with auditors regarding financial statements	<i>Company/Auditors</i>
October 13 – 18	Draft Q3 earnings release	<i>Company</i>
October 18	Distribute 10-Q, including financial statements and notes, and Q3 earnings release to legal counsel and auditors	<i>Company</i>
October 18 – 23	Legal counsel and auditors review and provide comments on 10-Q and Q3 earnings release	<i>Legal Counsel/Auditors</i>
October 24	Comments due back on 10-Q, including financial statements and notes, and Q3 earnings release from legal counsel and auditors	<i>Legal Counsel/Auditors</i>
October 24 – 31	Revise Q3 financial statements, 10-Q and Q3 earnings release	<i>Company/Legal Counsel/Auditors</i>
October 27	Disclosure Practices Committee Meeting regarding issues relating to Q3 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-Q and CEO/CFO certifications	<i>Company</i>
October 31	Distribute Q3 financial statements, 10-Q and Q3 earnings release to Audit Committee	<i>Company</i>
November 1	Prepare and distribute time and responsibility schedule for next year's annual proxy statement and annual reporting season to management, legal counsel and auditors	<i>Company</i>
November 1 – 2	Hold CEO/CFO 10-Q certifications diligence session with Disclosure Practices Committee to review 10-Q, review disclosure controls and procedures and internal control over financial reporting and obtain CEO/CFO certifications and applicable subcertifications for 10-Q	<i>Company</i>

Date*	Item	Responsibility
	Prepare script and management for Q3 earnings release conference call	<i>Company</i>
November 6	Audit Committee Meeting/Conference Call to: <ul style="list-style-type: none"> • Review Q3 financial results, including the earnings release • Review 10-Q • Review Disclosure Practices Committee report relating to Q3 • Review CEO/CFO reporting and disclosure philosophy and internal communications and reporting design to set “tone at the top” for preparation of 10-K and financial statements • Review auditors’ report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between auditors and management, including the management letter 	<i>Company</i>
November 6 – 9	Release Q3 numbers in earnings release; conference call regarding Q3 financial results <i>(Make applicable financial information available on website and applicable report filing with SEC; send required number of copies of press release materials to applicable exchange)</i>	<i>Company</i>
	File 10-Q for Q3 with SEC	<i>Company</i>
	In connection with the XBRL reporting requirements: <ul style="list-style-type: none"> • File the XBRL file as Exhibit 101 to 10-Q at the time 10-Q is filed with SEC • Post the XBRL file on company’s website by the end of the calendar day in which the XBRL exhibit has been submitted to SEC or was required to be submitted, whichever is earlier 	<i>Company</i>
November 14	Board Meeting and Committee Meetings	<i>Company</i>
November 29 – December 6 <i>(assuming definitive annual proxy materials for last annual meeting were distributed to shareholders between March 29 and April 5)</i>	Final date for receipt of Rule 14a-8 shareholder proposals to be included in annual meeting proxy statement for upcoming year <i>(Rule 14a-8 under the 1934 Act generally requires that shareholder proposals be received by company at corporate headquarters no later than 120 days prior to the date of distribution of previous year’s proxy materials if upcoming annual meeting is scheduled to be held within 30 days of previous year’s annual meeting; if not, then the last day for Rule 14a-8 shareholder proposals is a “reasonable” time before printing proxy materials for upcoming annual meeting)</i>	<i>Company</i>

Appendix 2

Form 8-K Reportable Events and Filing Deadlines

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Entry Into a Material Definitive Agreement (or a Material Amendment of a Material Definitive Agreement)*	Item 1.01	Within four business days	Generally, agreements required to be filed as exhibits to Form 10-K or 10-Q under Item 601 of Regulation S-K will trigger Form 8-K disclosure, other than executive compensation agreements. Companies are encouraged, but not required, to file copies of the agreements as exhibits to Form 8-K. If not filed with the Form 8-K, the agreements will be filed as exhibits to the company's next periodic report or applicable registration statement.
Termination of a Material Definitive Agreement*	Item 1.02	Within four business days	No disclosure required if agreement terminates by expiration on its stated termination date or upon the parties' completion of their obligations under the agreement, or if the company believes in good faith that the agreement has not been terminated, unless the company has received notice of termination pursuant to agreement terms.
Bankruptcy or Receivership	Item 1.03	Within four business days	Triggered by appointment of a receiver in federal or state bankruptcy proceeding or by entry of an order confirming a plan of reorganization, arrangement or liquidation.
Completion of Acquisition or Disposition of Assets	Item 2.01	Within four business days	Report acquisition or disposition of a significant amount of assets other than in the ordinary course of business.
Results of Operations and Financial Condition	Item 2.02	Within four business days	Triggered by public announcement/release of material nonpublic information (or update of such information) regarding financial results/condition for a completed fiscal year or quarter (other than in Form 10-Q or 10-K). A quarterly earnings release will be filed under this Item.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
<p>Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement*</p>	<p>Item 2.03</p>	<p>Within four business days</p>	<p>Triggered by:</p> <ul style="list-style-type: none"> • Entering into an enforceable agreement under which a material direct financial obligation will arise or be created. If no agreement, then triggered by closing or settlement of the transaction under which the direct financial obligation arises or is created. • Becoming directly or contingently liable for an obligation that is material arising out of an off-balance sheet arrangement. If the company or an affiliate is not party to the transaction or agreement creating a contingent obligation arising under the off-balance sheet arrangement, the Form 8-K report may be filed on the earlier of (a) the fourth business day after the contingent obligation is created or arises or (b) the day on which an executive officer becomes aware of the contingent obligation. • Entering into an agreement, transaction or arrangement that comprises a facility, program or similar arrangement that creates or may give rise to direct financial obligations in connection with multiple transactions. <p>A <i>direct financial obligation</i> is a long-term debt obligation, capital lease obligation, operating lease obligation, or short-term debt obligation arising other than in the ordinary course of business.</p>
<p>Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement*</p>	<p>Item 2.04</p>	<p>Within four business days</p>	<p>Triggered by the occurrence of an event of default, event of acceleration or similar “triggering” event that accelerates or increases a direct financial obligation or an obligation under an off-balance sheet arrangement with consequences material to the company.</p>

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Costs Associated with Exit or Disposal Activities*	Item 2.05	Within four business days	Triggered when the Board or an authorized officer commits the company to an exit or disposal plan, or otherwise disposes of a long-lived asset or terminates employees under a plan of termination, under which the company will incur a material write-off or restructuring charge.
Material Impairments*	Item 2.06	Within four business days	Triggered when the Board or an authorized officer concludes that a material change for impairment to one or more assets, including impairments of securities or goodwill, is required under GAAP (except if conclusion is in connection with the preparation, review or audit of financial statements included in a timely filed periodic report).
Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing	Item 3.01	Within four business days	<p>Triggered by:</p> <ul style="list-style-type: none"> • Receipt of notice from the NYSE, Nasdaq or other domestic exchange of failure to satisfy continued listing standards, or that the exchange has taken delisting action; • Receipt of public reprimand letter or similar communication from the NYSE, Nasdaq or other exchange that indicates the company has violated a continued listing standard; • Notice by the company to the NYSE, Nasdaq or other exchange of any material noncompliance with a continued listing standard; or • Definitive Board or authorized officer action to withdraw listing from the NYSE, Nasdaq or other exchange.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Unregistered Sales of Equity Securities	Item 3.02	Within four business days	<p>Triggered by <i>sale</i>, but only if the securities sold, in the aggregate since the company's last report under this Item or its last periodic report, constitute 1% or more of the number of shares outstanding (5% or more for a smaller reporting company). <i>Sale</i> occurs when company enters into an enforceable agreement under which equity securities are to be sold. If there is no written agreement, <i>sale</i> occurs on date of closing or settlement of the sale. <i>Shares outstanding</i> include only actual shares outstanding (not convertible securities).</p> <p>Any disclosure not required to be reported under this Item on Form 8-K – because it does not meet Form 8-K size threshold – will continue to be required to be reported on Forms 10-Q and 10-K.</p>
Material Modification to Rights of Security Holders	Item 3.03	Within four business days	Triggered by material modification to instruments (like articles of incorporation) that define the rights of shareholders or other security holders, or by the issuance or modification of any other securities that has a material adverse impact on those rights.
Changes in Certifying Accountant	Item 4.01	Within four business days	Triggered by resignation or dismissal of accountant or its refusal to stand for reappointment and, as a separate reportable event, by the engagement of a new accountant.
Nonreliance on Previously Issued Financial Statements*	Item 4.02(a)	Within four business days	Triggered when the Board, a Board Committee or an authorized officer concludes that any previously issued financial statements no longer should be relied on because of an error in those financial statements.
Nonreliance on Previously Issued Audit Report or Completed Interim Review	Item 4.02(b)	Within four business days	Triggered when the company is advised by its independent accountant that the company should make disclosure or take action to prevent further reliance on a previously issued audit report or interim review related to previously issued financial statements.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Changes in Control	Item 5.01	Within four business days	Triggered when the Board, a Board Committee or an authorized officer has knowledge that a change in control of the company has occurred.
Departure of a Director as a Result of a Disagreement or Removal for Cause	Item 5.02(a)	Within four business days	Triggered when a director resigns or refuses to stand for reelection because of a disagreement with the company's operations, policies or practices, and that disagreement is known to an executive officer. If the director furnishes the company with any written correspondence concerning the circumstances surrounding the director's departure, the company must file the correspondence as an exhibit to the Form 8-K. The company must also provide the Form 8-K disclosure to the director – not later than the day it is filed – and give the director an opportunity to furnish a letter stating whether the director agrees with the company's disclosures. If provided, the director's response letter must be filed as an exhibit by amendment to the previously filed Form 8-K within two business days of receipt by the company.
Any Other Departure of a Director or Any Departure of a Principal Officer or Named Executive Officer	Item 5.02(b)	Within four business days	Triggered by notice of a decision to resign, retire, refuse to stand for reelection, or termination (or demotion in responsibilities or duties), except in circumstances covered by Item 5.02(a). Whether communications represent discussion or consideration, on the one hand, or notice of a decision, on the other, is a facts and circumstances determination. Principal officers include the company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions. The named executive officers are those listed in the most recent proxy statement.
Appointment of a New Principal Officer	Item 5.02(c)	Within four business days	Triggered on date of appointment. However, if the company intends to make the first public announcement of the appointment other than by means of a Form 8-K after an applicable Form 8-K would otherwise be due, the company may file the Form 8-K on the day on which the company first publicly announces the appointment.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Election of a New Director Other Than by Shareholder Vote	Item 5.02(d)	Within four business days	Form 8-K is not required if the election is by vote of the shareholders at an annual meeting or a meeting called for that purpose.
Entry into or Amendment of Material Compensation Arrangement*	Item 5.02(e)	Within four business days	Applies to principal executive officer, principal financial officer and named executive officers. A termination should be disclosed if it constitutes a material amendment or modification.
Salary and Bonus Omitted from Summary Compensation Table	Item 5.02(f)	Within four business days	If a company omits from the Summary Compensation Table in its annual report or proxy statement, as applicable, the value of the salary or bonus earned by a named executive officer because it cannot calculate the value prior to filing its annual report or proxy statement, this Item requires the company to file a Form 8-K to report this information as soon as the amounts are calculable in whole or in part.
Amendments to the Company's Articles of Incorporation or Bylaws Other Than by Shareholder Vote	Item 5.03(a)	Within four business days	Form 8-K is not required if the amendments were adopted by the shareholders pursuant to a previously filed proxy statement.
Change in Fiscal Year Other Than by Shareholder Vote	Item 5.03(b)	Within four business days	Form 8-K is not required if the change is approved by a shareholder vote through the solicitation of proxies or is effected through an amendment to the company's articles of incorporation or bylaws.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Temporary Suspension of Trading Under Company's Employee Benefit Plans	Item 5.04	Within four business days	Triggered by receipt of notice from the plan administrator of a pension fund trading blackout period. If notice is not received, then triggered by a Regulation BTR notification from the company to an affected officer or director of a pension fund trading blackout period. (We discuss Regulation BTR in more detail in Chapter 4.)
Amendment to the Company's Code of Ethics or Waiver of a Provision of the Code of Ethics	Item 5.05	Within four business days	Form 8-K filing is not required if the company provides the required disclosure on its website within four business days, and the company disclosed in its most recently filed Form 10-K its website address and intention to provide disclosure in this manner. This information must remain on the company's website for 12 months. (A company need not disclose technical, administrative or other nonsubstantive amendments to its code of ethics.) A waiver must only be disclosed when it relates to a material departure from a provision of the company's code of ethics.
Change in Shell Company Status	Item 5.06	Within four business days	If a company that was a shell company (other than a shell company related to a business combination) completes a transaction that effectively causes the company to cease being a shell company, then the material terms of the transaction need to be disclosed under this Item.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Submission of Matters to a Vote of Security Holders	Item 5.07	Within four business days	<p>Preliminary voting results must be disclosed within four business days if final voting totals are not available; if preliminary results are filed, final voting results must be filed as an amended report on Form 8-K.</p> <p>No later than 150 days after the end of a meeting at which shareholders vote on the frequency of the Say-on-Pay vote, the company's decision in light of that vote as to how frequently the company will include the Say-on-Pay vote in its proxy materials must be disclosed by amendment to the original Form 8-K disclosing the meeting's voting results.</p>
Events Related to Asset-Backed Securities	Items 6.01 - 6.05	Within four business days	<p>These Items require the reporting of various events applicable to asset-backed securities, including the filing of ABS informational and computational materials, change of servicer or trustee, change in credit enhancement or other external support, failure to make a required distribution, and significant change (5% or more) in the asset pool relating to an offering of asset-backed securities.</p>
Regulation FD Disclosure	Item 7.01	Comply with Regulation FD timing requirements	<p>This Item can be used to comply with Regulation FD disclosure requirements. Disclosure under this Item is deemed to be "furnished" and not "filed," unless the company provides that information is to be deemed "filed."</p>
Other Events	Item 8.01	No specific timing requirement	<p>Voluntary disclosure of any events, with respect to information not otherwise required by Form 8-K, that the company deems of importance to shareholders. The company may file a report under this Item disclosing the nonpublic information required to be disclosed by Regulation FD. Unlike a filing under Item 7.01, disclosure under this Item is deemed to be "filed," not "furnished."</p>

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Financial Statements and Exhibits	Item 9.01	Financial statements required by Item 9.01 will be filed with initial Item 2.01 Form 8-K report (or by amendment not later than 71 calendar days after the date that initial Form 8-K is filed). Other required exhibits are filed as required by the relevant Form 8-K Item.	Requires filing of financial statements and pro forma financial information for business acquisitions required to be described under Item 2.01 of Form 8-K. Also calls for filing of other exhibits required by the relevant Form 8-K Item or Item 601 of Regulation S-K.

*These Items are subject to a limited safe harbor from public and private claims under Section 10(b) of the Securities Exchange Act of 1934, as amended (1934 Act), and Rule 10b-5 under the 1934 Act for a failure to timely file a Form 8-K. The safe harbor extends only until the due date of the next periodic report for the relevant period in which the Form 8-K was not timely filed. In addition, failure to timely file these Items will not impair eligibility to use short-form registration statements on Form S-3 so long as the required Form 8-K is filed on or before the date of filing of the Form S-3 and otherwise meets the safe harbor requirements.

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Appendix 3

Directors' and Officers' Liability Insurance: A Visual Guide

Side A Coverage	Side B Coverage	Side C Coverage
Protects directors and officers when company cannot indemnify individuals because of legal prohibitions or cost	Reimburses company for its indemnification of directors and officers	Covers the company for claims made against it

HYPOTHETICAL POLICY PERIOD – JULY 1, 2019 TO JUNE 30, 2020

\$100M	<p>XYZ Insurance Co. \$75M Coverage Limit (Side A) (\$500K Premium)</p>	<p>NO COVERAGE</p>	<p>NO COVERAGE</p>
\$25M	<p>ABC Insurance Co. \$25M Coverage Limit (Side A, Side B & Side C) (\$1.5M Premium)</p>		
<p>\$5M Retention: Company's Obligation</p>			

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APPENDIX 4

NYSE Initial Listing Standards

This table summarizes the main NYSE initial listing standards applicable to most U.S. companies (investment companies, SPACs, foreign entities, affiliated companies, REITs and companies seeking to list only debt or preferred securities, for example, will have some special standards) using publicly available information on the NYSE's website as of November 2011.

Distribution and Size Standards (must satisfy criteria for <i>each</i> of the following three standards)	
1. Shareholders	
<u>For companies listing in connection with an IPO:</u>	
Round-lot (generally 100 shares) holders, including beneficial owners of "street name" shares	400
<u>For companies listing in connection with a transfer:</u>	
Round-lot (generally 100 shares) holders, including beneficial owners of "street name" shares	400
OR	
Total Shareholders	2,200
together with:	
Average Monthly Trading Volume (for the most recent 6 months)	100,000 shares
OR	
Total Shareholders	500
together with:	
Average Monthly Trading Volume (for most recent 12 months)	1 million shares
2. Number of Publicly Held Shares	1.1 million shares

Distribution and Size Standards (must satisfy criteria for <i>each</i> of the following three standards)	
3. Market Value of Public Shares	
IPOs, Spin-offs, Carve-outs	\$40 million
All other listings (such as transfers of public companies)	\$100 million
<p>Shares held by directors and officers (and their immediate families) and other concentrated holdings of 10% or more are excluded when calculating the number of publicly held shares.</p> <p>If a company either has a significant concentration of stock or changing market forces have adversely impacted the public market value of a company that otherwise would qualify for NYSE listing so that its public market value is no more than 10% below the minimum, the NYSE will consider shareholders' equity of \$40 million or \$100 million, as applicable, as an alternate measure of size.</p>	
Stock Price Criteria	
Stock price at the time of initial listing	\$4.00
Financial Standards (must satisfy one of the following standards)	
Alternative #1 – Earnings	
Aggregate pre-tax income for the last 3 years*	\$10 million
Minimum pre-tax income for each of the 2 most recent years	\$2 million
*All 3 years must have positive pre-tax income	
OR:	
Aggregate pre-tax income for the last 3 years	\$12 million
Minimum pre-tax income for the most recent year	\$5 million
Minimum pre-tax income for the next most recent year	\$2 million

Financial Standards (must satisfy one of the following standards)	
Alternative #2a – Valuation with Cash Flow	
Global market capitalization	\$500 million
Revenues (most recent 12-month period)	\$100 million
Adjusted cash flow:	
Aggregate for the last 3 years*	\$25 million
* All 3 years must have positive cash flow	
Alternative #2b – Pure Valuation with Revenues	
Global market capitalization	\$750 million
Revenues (for the most recent fiscal year)	\$75 million
Alternative #3 – Assets and Equity	
Global market capitalization	\$150 million
Total assets	\$75 million
Shareholders' equity	\$50 million

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NYSE Continued Listing Standards

This table summarizes the main NYSE continued listing criteria applicable to most U.S. companies (investment companies, SPACs, foreign entities, affiliated companies, REITs and companies that have only listed debt or preferred securities, for example, will have some special standards) using publicly available information on the NYSE's website as of November 2011. When a company falls below any of these criteria, the NYSE usually gives consideration to prompt initiation of suspension and delisting procedures.

Stock Price Criteria	
Average closing price of the listed security over a consecutive 30-trading-day period is less than	\$1.00
Financial Criteria	
For companies that listed under the Earnings standard or the Assets and Equity standard	
Average global market capitalization over a consecutive 30-trading-day period is less than	\$50 million
<i>AND</i>	
Total shareholders' equity is less than	\$50 million
<i>OR</i>	
Average global market capitalization over a consecutive 30-trading-day period is less than	\$15 million
For companies that listed under the Valuation with Cash Flow standard	
Average global market capitalization over a consecutive 30-trading-day period is less than	\$250 million
<i>AND</i>	
Total revenues over the last 12 months are less than	\$20 million
<i>OR</i>	
Average global market capitalization over a consecutive 30-trading-day period is less than	\$75 million

Financial Criteria	
For companies that listed under the Pure Valuation with Revenues standard	
Average global market capitalization over a consecutive 30-trading-day period is less than	\$375 million
<i>AND</i>	
Total revenues over the last 12 months are less than	\$15 million
<i>OR</i>	
Average global market capitalization over a consecutive 30-trading-day period is less than	\$100 million
Distribution Criteria	
Number of publicly held shares is less than... ..	600,000 shares
Number of total shareholders is less than	400
Number of total shareholders when average monthly trading volume (for most recent 12 months) falls below 100,000 shares is less than	1,200
Qualitative Requirements	
Continued compliance with NYSE corporate governance standards	See Chapter 8
Absence of certain changes in a company's ongoing corporate status (e.g., sale or intent to cease use for any reason of substantial portion of operating assets; intent to file for bankruptcy or liquidation)	Discuss with the NYSE as applicable

APPENDIX 5

The Nasdaq Global Select Market – Initial Listing Standards

This table summarizes the main Nasdaq Global Select Market initial listing standards using publicly available information on Nasdaq's website as of November 2011. Companies (other than closed-end management investment companies that have separate criteria) must meet all of the criteria under at least one of the following financial standards and the applicable liquidity standards below.

FINANCIAL AND QUALITATIVE STANDARDS

Standards	Standard 1	Standard 2	Standard 3	Standard 4
Minimum Bid Price	\$4.00	\$4.00	\$4.00	\$4.00
Market Makers* . . .	3 or 4	3 or 4	3 or 4	3 or 4
Market Capitalization . . .	N/A	Prior 12-month average at least \$550 million (if at IPO calculated at time of initial listing)	Prior 12-month average at least \$850 million (if at IPO calculated at time of initial listing)	At least \$160 million (if at IPO calculated at time of initial listing)
Shareholders' Equity	N/A	N/A	N/A	\$55 million
Pre-Tax Earnings . . . (income from continuing operations before income taxes)	Aggregate \$11 million in prior three fiscal years AND \$2.2 million in each of two most recent fiscal years AND at least \$0 in each of prior three fiscal years	N/A	N/A	N/A
Cash Flows	N/A	Aggregate \$27.5 million in prior three fiscal years AND at least \$0 in each of prior three fiscal years	N/A	N/A
Revenue	N/A	At least \$110 million in previous fiscal year	At least \$90 million in previous fiscal year	N/A
Total Assets	N/A	N/A	N/A	At least \$80 million
Corporate Governance	Yes	Yes	Yes	Yes

* A company that also satisfies either the Income Standard or the Equity Standard under the Nasdaq Global Market - Initial Listing Standards (see below) is required to have only three market makers. Otherwise, a company is required to have four market makers.

LIQUIDITY STANDARDS

Standards	IPO and Spin-Off Companies	Seasoned Companies: Currently Trading Common Stock or Equivalents	Companies Affiliated with Another Company Listed on the Nasdaq Global Select Market
(a) Round-Lot Shareholders or (b) Total Shareholders OR (c) Total Shareholders and Average Monthly Trading Volume (for past 12 months)	(a) 450 or (b) 2,200 (c) N/A	(a) 450 or (b) 2,200 OR (c) 550 and 1.1 million	(a) 450 or (b) 2,200 OR (c) 550 and 1.1 million
Publicly Held Shares	1,250,000	1,250,000	1,250,000
(a) Market Value of Publicly Held Shares OR (b) Market Value of Publicly Held Shares and Shareholders' Equity	(a) \$45 million (b) N/A	(a) \$110 million OR (b) \$100 million and \$110 million	(a) \$45 million (b) N/A

The Nasdaq Global Market – Initial Listing Standards

This table summarizes the main Nasdaq Global Market initial listing standards using publicly available information on Nasdaq's website as of November 2011. Companies (other than closed-end management investment companies that have separate criteria) must meet all of the criteria under at least one of the four standards below.

Standards	Income Standard	Equity Standard	Market Value Standard*	Total Assets/ Total Revenue Standard
Minimum Bid Price	\$4.00	\$4.00	\$4.00	\$4.00
Market Makers	3	3	4	4
Market Value of Publicly Held Shares	\$8 million	\$18 million	\$20 million	\$20 million
Shareholders' Equity	\$15 million	\$30 million	N/A	N/A
Shareholders	400	400	400	400
(round-lot holders – generally 100 shares)				
Income from Continuing Operations Before Income Taxes	\$1 million	N/A	N/A	N/A
(in Latest Fiscal Year OR in Two of Last Three Fiscal Years)				
Market Value of Listed Securities	N/A	N/A	\$75 million	N/A
(Securities Listed on Nasdaq or Another National Securities Exchange)				
Total Assets AND Total Revenue	N/A	N/A	N/A	\$75 million AND \$75 million
(in Latest Fiscal Year OR in Two of Last Three Fiscal Years)				
Publicly Held Shares	1.1 million	1.1 million	1.1 million	1.1 million
(Shares Outstanding Less Any Shares Directly or Indirectly Held by Officers, Directors or Beneficial Owners of 10%)				
Operating History	N/A	2 years	N/A	N/A
Corporate Governance	Yes	Yes	Yes	Yes

* Seasoned companies (companies already on another marketplace) qualifying only under the Market Value Standard must meet market value of listed securities and bid price standards for 90 consecutive trading days prior to applying for listing on The Nasdaq Global Market.

The Nasdaq Capital Market – Initial Listing Standards

This table summarizes the main Nasdaq Capital Market initial listing standards using publicly available information on Nasdaq's website as of November 2011. Companies (other than closed-end management investment companies that have separate criteria) must meet all of the criteria under at least one of the three standards below.

Standards	Equity Standard	Market Value Standard*	Net Income Standard
Minimum Bid Price	\$4.00	\$4.00	\$4.00
Market Makers	3	3	3
Market Value of Listed Securities	N/A	\$50 million	N/A
(Securities Listed on Nasdaq or Another National Securities Exchange)			
Shareholders	300	300	300
(round-lot holders – generally 100 shares)			
Shareholders' Equity	\$5 million	\$4 million	\$4 million
Market Value of Publicly Held Shares	\$15 million	\$15 million	\$5 million
Operating History	2 years	N/A	N/A
Net Income from Continuing Operations	N/A	N/A	\$750,000
(in Latest Fiscal Year OR in Two of Last Three Fiscal Years)			
Publicly Held Shares	1 million	1 million	1 million
(Shares Outstanding Less Any Shares Directly or Indirectly Held by Officers, Directors or Beneficial Owners of 10%)			
Corporate Governance	Yes	Yes	Yes

* Seasoned companies (companies already on another marketplace) qualifying only under the Market Value Standard must meet market value of listed securities and bid price standards for 90 consecutive trading days prior to applying for listing on The Nasdaq Capital Market.

The Nasdaq Global Select Market and The Nasdaq Global Market – Continued Listing Standards

This table summarizes the main Nasdaq Global Select Market and Nasdaq Global Market continued listing standards using publicly available information on Nasdaq’s website as of November 2011.

Standards	Equity Standard	Market Value Standard	Total Assets/ Total Revenue Standard
Minimum Closing Bid Price*	\$1.00	\$1.00	\$1.00
Market Makers**	2	4	4
Total Shareholders	400	400	400
Shareholders’ Equity	\$10 million	N/A	N/A
Market Value of Listed Securities* (Securities Listed on Nasdaq or Another National Securities Exchange)	N/A	\$50 million	N/A
Total Assets AND Total Revenue (in Latest Fiscal Year OR in Two of Last Three Fiscal Years)	N/A	N/A	\$50 million AND \$50 million
Publicly Held Shares (Shares Outstanding Less Any Shares Directly or Indirectly Held by Officers, Directors or Beneficial Owners of 10%)	750,000	1.1 million	1.1 million
Market Value of Publicly Held Securities*	\$5 million	\$15 million	\$15 million
Continued Compliance with Corporate Governance Standards	Yes	Yes	Yes

* Company will be noncompliant if standard is not met for a period of 30 consecutive business days.

** Company will be noncompliant if standard is not met for a period of 10 consecutive business days.

The Nasdaq Capital Market – Continued Listing Standards

This table summarizes the main Nasdaq Capital Market continued listing standards using publicly available information on Nasdaq's website as of November 2011.

Standards	Equity Standard	Market Value Standard	Net Income Standard
Minimum Closing Bid Price*	\$1.00	\$1.00	\$1.00
Market Makers**	2	2	2
Public Holders	300	300	300
(Shares Outstanding Less Any Shares Directly or Indirectly Held by Officers, Directors or Beneficial Owners of 10%)			
Shareholders' Equity	\$2.5 million	N/A	N/A
Market Value of Listed Securities*	N/A	\$35 million	N/A
(Securities Listed on Nasdaq or Another National Securities Exchange)			
Net Income from Continuing Operations	N/A	N/A	\$500,000
(in Latest Fiscal Year or in Two of Last Three Fiscal Years)			
Publicly Held Shares	500,000	500,000	500,000
(Shares Outstanding Less Any Shares Directly or Indirectly Held by Officers, Directors or Beneficial Owners of 10%)			
Market Value of Publicly Held Securities*	\$1 million	\$1 million	\$1 million
Continued Compliance with Corporate Governance Standards	Yes	Yes	Yes

* Company will be noncompliant if standard is not met for a period of 30 consecutive business days.

** Company will be noncompliant if standard is not met for a period of 10 consecutive business days.

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