the Corporate Governance advisor

July/August 2013 • Volume 21, Number 4

SHAREHOLDER MEETINGS

Debunking the Myths Behind Voting Instruction Forms and Vote Reporting

By Keir D. Gumbs, Todd Hamblet, and Kristin Stortini

Two recent developments have refocused the attention of companies and stockholders on the plumbing of the proxy apparatus that gives effect to the proxy rules adopted by the Securities and Exchange Commission (SEC). The first development was an announcement by Broadridge Financial Solutions, Inc. (Broadridge) and other proxy distribution service providers, including Computershare Investor Services (Computershare), that they were changing the manner in which they solicited voting instructions and proxies from stockholders. For example, Broadridge and Computershare announced that they would remove a "vote with management" voting option from their telephone, Internet and mobile device voting platforms.[1]

The second development involves recent high-profile attention related to the dissemination of

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preliminary voting reports for upcoming meetings of stockholders. In response to various media reports regarding vote reporting, Senator Chuck Schumer wrote a letter to Mary Jo White, Chairman of the SEC, urging the SEC to adopt rules regarding the practice of vote reporting so that proxy distribution service providers can have "clear rules of the road" with respect to proxy solicitation disclosures.[2] In light of these recent developments, many have asked about the rules and regulations that govern proxy solicitations, the voting process, and vote reporting. Through a series of questions and answers, this article seeks to "debunk the myths" surrounding voting instruction forms and vote reporting in the context of a proxy solicitation.

Background

A holder of shares of stock in the United States generally may hold stock in one of two ways: A stockholder may be a "record" or "registered" stockholder, which refers to a stockholder that holds an issuer's shares directly and is listed in the issuer's records as a stockholder (collectively referred to in this article as "record stockholders"); or a stockholder may hold shares as a "street name" holder or a "beneficial owner," which refers to a stockholder that holds shares through a nominee, such as a broker or a bank (collectively referred to in this article as "beneficial owners").[3] Most stockholders in the United States fall into the latter category and are beneficial owners.

There are important distinctions between holding stock as a record stockholder and holding stock as a beneficial owner. Under state law, a record stockholder has technical ownership of the shares and any rights associated with that ownership, including the right to vote. In addition, an issuer maintains information about a record stockholder (including the identity of the stockholder, its name, address and similar information), typically through a transfer agent. In contrast, a bank or broker is generally the record holder of securities held on behalf of beneficial owners and, consequently, it is the broker or bank that is entitled to vote the shares held on behalf of its beneficial owner clients.[4] Further, an issuer may only obtain information regarding beneficial owners by requesting a list of its "Non-Objecting Beneficial Owners" from the proxy distribution service providers, such as Broadridge and Computershare, acting on behalf of a broker or bank.

In light of the structure of stock ownership described above, the SEC has adopted rules under the Securities Exchange Act of 1934 (Exchange Act) that require a bank or broker to distribute to their beneficial owner clients any proxy soliciting materials received from an issuer or any other soliciting person (which may be a third party).[5] The New York Stock Exchange (the NYSE) and the Financial Industry Regulatory Authority (FINRA) have adopted similar rules. Specifically, Rule 14b-1 and Rule 14b-2 of the Exchange Act provide that a broker or bank that receives proxy soliciting materials from an issuer or other soliciting person must forward that material to the broker's or bank's customers that own beneficial title to that issuer's securities. This obligation also exists under NYSE Rule 451 and FINRA Rule 2251.[6] Brokers and banks are required to distribute these materials unless the soliciting party fails to provide assurance of reimbursement of the reasonable expenses incurred for distributing the materials.[7] These rules are intended to ensure that beneficial owners receive timely notice and delivery of proxy materials and other corporate communications for securities that are held through intermediaries.[8]

In many cases, the proxy soliciting materials that brokers and banks are required to forward to beneficial owners will include a proxy or other request for voting instructions, which must be collected from beneficial owners. In the case of a proxy, the proxy soliciting materials will include instructions as to how to transmit the proxy to the soliciting person. There is, however, no precise manner in which voting instructions must be collected.[9] Thus, a broker or bank has significant latitude in soliciting voting instructions.

As a result of these rules, the distribution of proxy materials to beneficial owners involves a three-step process:

- An issuer or other soliciting person provides a broker or bank with its proxy soliciting materials;
- The broker or bank distributes those materials along with a request for voting instructions, if applicable, to its beneficial owner clients; and
- The broker or bank collects the voting instructions and votes in accordance with such instructions on behalf of its beneficial owner clients.[10]

The NYSE and FINRA also have adopted rules that constrain a broker or bank from voting shares on behalf of their beneficial owner clients in the absence of specific voting instructions.[11]

What Is a Voting Instruction Form, and How Does It Work?

A voting instruction form (VIF) is the mechanism by which a broker or bank collects voting instructions from its beneficial owner clients. As described by the SEC, a VIF "allows a beneficial owner to instruct his or her broker or other securities intermediary how to vote their shares at company meetings."[12] The bank or broker record holder collects these VIFs and then casts a vote according to the instructions on the VIF.[13] Voting instructions can be collected through paper VIFs, or through telephone, Internet or mobile device voting platforms.

Are VIFs Subject to the Proxy Rules or Other Requirements?

Yes. When a broker or bank sends a VIF, it is engaging in a "solicitation" under Rule 14a-1.[14] Even though a request for voting instructions involves a solicitation, such solicitations have been exempt solicitations under the proxy rules since at least 1952.[15] The relevant exemption, Rule 14a-2(a)(1), applies to "any solicitation by a person in respect of securities carried in his name or held in his custody" if such person:[16]

- Receives no compensation other than the reimbursement of expenses;
- Furnishes to all persons solicited copies of soliciting material furnished to him for that purpose; and
- Does no more than "impartially" (a) instruct the person solicited as to how to transmit the proxy to the person who is originally soliciting it, or (b) request instructions as to the giving of a proxy.

Proxy solicitations made pursuant to Rule 14a-2(a)(1) are exempt from a number of the proxy rules, including Rules 14a-3 through 14a-15 (which rules include the requirement to prepare and file a proxy statement), and excuse a VIF from the specific form requirements that apply to proxies under Rules 14a-4 and 14a-5, the filing requirements imposed by Rule 14a-6, and the prohibition against materially misleading statements in a proxy contained in Rule 14a-9.[17]

How Has the Impartiality Requirement Discussed Above Been Applied?

There is very little guidance regarding the phrase "impartial" as included in Rule 14a-2(a)(1). A number of cases have found that the phrase generally means that "…the banker, broker or other person is acting in a ministerial capacity and is not making an independent solicitation from the beneficial owner."[18] Further, courts have indicated that the exemption will be lost if a broker transmits the material of one side promptly and delays transmission of the material of the other side, or passes on some but not all soliciting literature.[19] Moreover, the SEC has indicated that "we believe that if the firm transmits—along with a party's soliciting material—its own literature, which in any way relates to the merits of the solicitation, the broker is probably not acting in a ministerial capacity and thus not entitled to the exemption."[20]

What Are the Principal Differences between a VIF and a Proxy?

The following is a summary of the principal differences between a proxy and a VIF:

Proxy	Voting Instruction Form
Subject to Rule 14a-9.	Not subject to Rule 14a-9.
Subject to detailed requirements of proxy rules regarding form and content.	Subject to SEC-imposed impartiality requirement and limited NYSE rules regarding form and content.
Incomplete but executed forms may be voted with management's recommendations as long as the proxy indicates how it will be voted. *See* Rule 14a-4.[21]	Incomplete but executed voting instructions must be voted with management's recommendations. *See* NYSE Rule 451.
Reviewed by the SEC in context of general proxy review.	Reviewed by the SEC in context of questions from investors or issuers.
Prepared by soliciting party (issuer or investor), who is liable for contents; filed with the SEC.	Prepared by a bank, broker, or other nominee, who is subject to NYSE and SEC for content; not filed with the SEC.

What Is a "Vote with Management" Button?

Most proxy distribution service providers and transfer agents, including Broadridge and Computershare, allow stockholders to cast votes or provide voting instructions through a variety of channels, including through paper proxy cards and VIFs, as well through their proprietary telephonic, Internet and, more recently, mobile voting platforms. As a general matter, these channels present voting choices in a manner that is substantially similar to the presentation of such matters in a paper proxy card or VIF. One exception to this rule was the presentation of a "vote with management" option, which gave a stockholder the opportunity to, with one click of a button, vote a proxy or provide voting instructions in accordance with the recommendations of management.[22]

Why Did Transfer Agents, Brokers, and Banks Eliminate the "Vote with Management" Button?

In 2012, the staff of the SEC announced new interpretive guidance under Rule 14a-4 and Rule 14a-2(a)(1) under the proxy rules that impacted the "vote with management" button. Under the new guidance, the staff expressed the view that the presentation of a "vote with management" button without the presentation of a corresponding "vote against management" button was inconsistent with the plain language of Rule 14a-4 and the "impartiality" requirement of Rule 14a-2(a)(1).[23] Accordingly, the staff informed proxy distribution service providers and transfer agents that it would expect them to present a "vote against management" button on any platform that solicits proxies or voting instructions, to the extent that such platform also included a "vote with management" button.[24] Following the new guidance, Computershare, one of the largest transfer agents, and Broadridge, which acts as the agent for most brokers and banks, eliminated the "vote with management" option for the 2013 proxy season.[25]

What Is Interim Vote Reporting, and How Does It Work?

As a general matter, the phrase "interim vote reporting" refers to the practice of collecting votes or voting instructions and providing a summary of such votes or voting instructions to issuers or third parties conducting a proxy solicitation. In the case of a proxy solicitation involving record stockholders, interim voting reports are only provided to an issuer, since the issuer or its agent is the party that is collecting the votes. In contrast, in the case of a proxy solicitation of voting instructions from clients of brokers and banks, interim voting reports are provided to issuers *and* other parties conducting a proxy solicitation. This is due in part to the fact that the person collecting the voting instructions on behalf of brokers and banks is doing so as their agent and not as the agent of the issuer that is the subject of the solicitation. In fact, the practice of providing interim voting reports is a courtesy provided to issuers and third parties for whom solicitation materials have been distributed.

What Are the Rules Governing Interim Vote Reports?

There do not appear to be any SEC, NYSE, or FINRA rules that govern the practice of providing interim voting reports. As noted above, the information that is incorporated into an interim voting report is collected by brokers and banks as part of their solicitation of voting instructions on behalf of parties distributing soliciting materials. As such, the use of such information is largely determined by the brokers and banks who are responsible for distributing the soliciting materials, and such parties may direct their agents, including firms such as Broadridge, regarding the use of such information. Due to the agency relationship between the proxy distribution service providers and their broker and bank clients, the actions of the proxy distribution service providers are also governed by the agreements that establish the agency relationship.[26]

What Kinds of Solicitations Are Eligible for Interim Voting Reports?

Historically, Broadridge, as the largest agent for brokers and banks, provided interim voting reports with respect to any solicitation that is subject to the proxy rules, whether exempt or non-exempt. For example, Broadridge provided interim voting reports to issuers conducting routine proxy solicitations, third parties conducting contested proxy solicitations and, until recently, third parties conducting exempt proxy solicitations, such as "vote no" campaigns.

Were Stockholders Able to Receive Interim Voting Reports in Connection with Stockholder Proposals Included in a Company's Proxy Statement?

No. Historically, Broadridge's policy was limited to instances in which an issuer or third party was actually conducting a proxy solicitation (exempt or non-exempt). The inclusion of a stockholder proposal in a company's proxy materials is not a "solicitation" under the proxy rules. In contrast, a stockholder that distributes a letter to other stockholders to encourage them to support a stockholder proposal would be conducting a solicitation (albeit an exempt solicitation under Rule 14a-2(b)(1)), in which case it would have been eligible to receive an interim voting report if it actually distributed proxy soliciting materials to the clients of brokers and banks.

What Is Broadridge's New Policy with Respect to Interim Voting Reports?

Under a recently announced modification to its policy regarding interim voting reports, Broadridge will no longer provide interim voting reports to third parties conducting exempt solicitations in cases in which they are not distributing a voting instruction form or proxy (that is, exempt solicitations such as "vote no" campaigns, which do not involve the distribution of a proxy card). It will, however, continue to provide such reports to issuers and third parties conducting proxy solicitations if they are distributing a voting instruction form or proxy.

Is the Personal Information of Beneficial Owners Shared in Vote Reporting?

No. The voting data included in an interim voting report contains only aggregated data across Broadridge's various broker and bank clients. Such reports do not identify a particular beneficial owner by name or by any other identifiers, such as account number or address.

Notes

1. *See* Letter from Broadridge Financial Solutions, Inc. to its Clients (Dec. 20, 2012) (hereinafter the "Broadridge Letter"), available at *http://www.thecorporatecounsel.net/non-Member/docs/12_12_Vote.pdf*; email from Computershare to its Clients entitled "SEC Revision Impacts Web and IVR Voting for Upcoming Proxy Season" (October 29, 2012) (on file with author).

2. *See* Letter from Senator Charles Schumer to Commissioner Mary Jo White, US Sec. & Exch. Comm'n (May 23, 2013) (on file with author).

3. *See* Concept Release on the US Proxy System, SEC Rel. No. 34-62495 (July 22, 2010) (hereinafter the "Concept Release").

4. *Id.* at 42,985.

5. *See* Concept Release, *supra* note 3. When a bank or broker sends a VIF, it is engaging in a "solicitation" under Rule 14a-1.

6. *See* Exchange Act Rules 14b-1 and 14b-2; NYSE Rules, NY Stock Exchange, available at *http://rules.nyse.com/NYSETools/PlatformViewer.asp* (last visited June 6, 2013); FINRA Rules, FINRA Indus. Prof., available at *https://www.finra.org/Industry/Regulation/FINRARules/* (last visited June 6, 2013).

7. *See* Walsh v. Peoria & E. Ry. Co., 222 F. Supp. 516 (SDNY 1963).

8. *See* SEC Rel. No. 34-23847 (Nov. 25, 1986).

9. *See* Concept Release, *supra* note 3. Broadridge and other proxy distribution service providers act as agents for a broker or bank in distributing proxy soliciting materials. These proxy distribution service providers operate under a contract with a bank or a broker whereby proxy distribution service providers, for a fee, take over the obligation of the banks and brokers to distribute proxy soliciting materials. Thus, as an agent of the banks and brokers, companies like Broadridge are obligated to distribute the soliciting materials to all beneficial owners of shares subject to the solicitation in the same manner required of the banks and brokers under the law.

10. *See* Concept Release, *supra* note 3.

11. *See* NYSE Rule 452. No similar rule exists for banks.

12. "Spotlight on Proxy Matters—Receiving Proxy Materials," US Securities and Exchange Comm. (May 24, 2012), *http://www.sec.gov/spotlight/proxymatters/proxy_materials.shtml*. In contrast, a proxy card is sent to record holders in lieu of a VIF. *Id.*

13. *Id.*

14. Rule 14a-1 defines a "solicitation" as (i) any request for a proxy whether or not accompanied by or included in a form of proxy; (ii) any request to execute or not to execute, or to revoke, a proxy; or (iii) the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

15. Securities and Exchange Commission, Securities Exchange Act Release, No. 4668 (January 31, 1952). This exemption was based, as the SEC has stated, "on the assumption that the banker, broker or other person is acting in a ministerial capacity and is not making an independent solicitation from the beneficial owner." It bears noting that other nominees, including, for example, the Trustee for a equity compensation plan that distributes a request for voting instructions, is also engaged in a solicitation under Rule 14a-2(a)(1).

16. Concept Release on the US Proxy System, SEC Rel. No. 34-62495, at 84 (July 14, 2010).

17. Note that Broadridge remains subject to Rule 14a-16 regarding Internet Availability of Proxy Materials when forwarding proxy materials and VIFs to beneficial owners.

18. SEC Rel. No. 34-4668 (Jan. 31, 1952).

19. *See* Walsh v. The Peoria & Eastern Railway Co., 63 Civ. 2003, (SDNY 1963) (brokers held to have violated the proxy rules when they failed to send copies of proxy solicitation materials to beneficial owners of stock and when they voted some of stock held in their names for management's candidate without beneficial owners' permission).

20. SEC Rel. No. 34-7208 (Jan. 7, 1964).

21. Rule 14a-4(b)(1) provides that a proxy may confer discretionary authority (such as a vote in favor of the board's recommendations) with respect to unspecified items on a proxy card that has been executed and returned, "provided that the form of proxy states in bold-face type how it is intended to vote the shares represented by the proxy in each such case."

22. Since VIFs are not subject to the specific form requirements imposed by Rule 14a-2, neither Rule 14a-2 nor any other proxy rule specifies the precise manner in which a broker or bank must collect voting instructions. Further, and as noted previously, the impartiality requirement of Rule 14a-2(a)(1) has been construed very narrowly such that a broker or bank conducting a solicitation under that rule only violates the rule if they (a) fail to distribute the proxy solicitation materials of one of the parties to a proxy contest, or (b) participate in a proxy contest by adding their own commentary in solicitation materials sent to shareholders.

23. This guidance was announced publicly by Tom Kim, the Chief Counsel of the SEC's Division of Corporation Finance, at the Annual SEC Speaks Conference in

Washington D.C. in February 2013. To the knowledge of the authors, this guidance has not been memorialized in any written staff guidance.

24. *See* "Proxy sites dump one-click vote button on SEC concerns," Ross Kerber, March 20, 2013, publicly available at *http://www.cnbc.com/id/100574479*.

25. In many ways, the staff's position with respect to the "vote with management" button and the "vote against management" button is an accommodation, as neither button is explicitly permitted by Rule 14a-4, which requires that shareholders be given the opportunity to vote on each matters under consideration individually. The sole exception to this rule may be found in Rule 14a-4(b)(2), which indicates that a form of proxy may provide a means for a shareholder to vote for the slate of the board's nominees for election as directors as a group *if* a shareholder be given the option to withhold authority to vote for such group of nominees (or to vote against such nominees if the company has adopted a majority voting standard for the election of directors). Rule 14a-4 allows a soliciting person to solicit votes for all of management's nominees or only gives a soliciting person the choice.

26. If a proxy distribution service provider acts on behalf of the issuer or the party conducting the solicitation, the obligations of the proxy distribution service provider would differ. Rule 14a-7 requires an *issuer* to distribute a soliciting party's proxy materials to its stockholders, while Rules 14b-1 and 14b-2 govern the obligation of a bank or broker to forward these materials to beneficial owners. Thus, the legal obligations are different depending on whether the proxy distribution service provider is an agent for the issuer or the banks and brokers.

Golden Leashes, Honest Brokers, Risk Tolerances & Market Imperfections: Incentive Schemes for Activist Investor Nominees

By Neil Whoriskey

Golden leashes, as compensation arrangements between activists and their nominees to target boards are known, have emerged as the latest advance (or atrocity, depending on your point of view) in the long-running battle between activists and defenders of the long-term investor faith. Just exactly what are we worried about?

With average holding periods for US equity investors having shriveled from five years in the 1980s to nine months or less today, the defenders of "long-termism" would seem to have lost the war, though perhaps not the argument. After all, if the average shareholder is only sticking around for nine months, and if directors owe their duties to their shareholders (average or otherwise), then at best a director on average will have nine months to maximize the value of those shares. Starting now. Or maybe starting nine months ago.

This assumes, however, that the directors of any particular company have a real idea of just how long their particular set of "average" shareholders will stick around, and it also assumes that the directors owe duties primarily to their average shareholders, and not to their Warren Buffett investors (on one hand) or their high-speed traders (on the other). So, in the absence of any real information about how long any then-current set of shareholders will hold an investment on average, and in the absence of any rational analytical framework to decide which subset(s) of shareholders they should be acting for, what are directors to do?

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Here is what I think directors do, in one form or fashion or another.

They say to themselves, "I have a good sense of what the company's opportunities are, in terms of long-term growth, and in terms of shorter-term options, like a share buyback, a spin-off, or a sale. Since I don't know how long any of my shareholders will be sticking around, what seems fair is to probability weight the various outcomes of share price increases from a long-term growth strategy versus the various shorter-term strategic alternatives, and decide based on the net present value of those probability-weighted outcomes, what yields the

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The ***CORPORATE GOVERNANCE ADVISOR*** (ISSN 1067-6171) is published bimonthly by Aspen Publishers at 76 Ninth Avenue, New York, NY 10011. Subscription rate, $670 for one year. POSTMASTER: Send address changes to *THE CORPORATE GOVERNANCE ADVISOR,* Aspen Publishers, 7201 McKinney Circle, Frederick, MD 21704. Send editorial correspondence to Aspen Publishers, 76 Ninth Avenue, New York, NY 10011. To subscribe, call 1-800-638-8437. For Customer service, call 1-800-234-1660. This material may not be used, published, broadcast, rewritten, copied, redistributed or used to create any derivative works without prior written permission from the publisher.

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highest current net present value." While no directors probably think exactly this way (unless they are confronted with a clear choice between, for example, doing a stock buyback versus embarking on an expensive capex program), I do think this reflects (albeit in a cartoonishly precise way) what directors are doing when they choose a strategic direction.

Assuming perfect knowledge and universal agreement on the correct probability weighting, risk tolerance and present value methodology, this approach should yield the highest share price at all times—regardless of any investor's timeframe—thus resolving once and forever the false debate between short-termism and long-termism.

Sort of. In fact, the problem still exists in the real world, due to the unfortunate lack of perfect knowledge,[1] and equally unfortunate disagreements regarding probability weighting, risk tolerances and, to a lesser degree, present value discount rates and methodologies. The short-termers (henceforth, in order to continue the theme of cartoonish oversimplification, "activist hedge funds") and the long-termers (in a similar vein, henceforth known as "management"), in particular seem to clash over probability weighting and, less openly though perhaps as fundamentally, risk tolerances.[2]

According to this narrative, activist hedge funds are constantly pushing for short-term actions—share buybacks, spin-offs, sales—either because they more heavily discount the probability of success of long-term actions (or simply think the broader market will too heavily discount the probability of success of a long-term strategy), or because they have a lower risk tolerance than management. Management, per this same narrative, is always too certain of the success of its long-term plans, or alternatively—in the most vitriolic forms of this narrative—is made up of entrenched self-dealing types who just don't care about their shareholders.

It may be worth pausing for just a moment on the two aspects of this analysis—probability weighting and risk tolerances—that are the implicit subject of many a long-term v. short-term battle.

In one sense, probability weighting of the success of various alternative strategies, although it is at the heart of the director's job, presents the simpler issue for our immediate purpose of determining which forms of incentives offered by activists to their board nominees may be improper. Either the board is correct in probability weighting the success of various strategies, or it is wrong to one degree or another. Individual shareholder preferences do not come into play, regardless of who the shareholders are; there is a right answer and a wrong answer. As in any "right or wrong" issue, the shareholders who are right in doing the probability weighting will be able to make money from investors who are wrong, and those who are wrong will lose money. And of course, if the board is wrong, then shareholders in the aggregate will lose money, regardless of their individual long- or short-term orientation. Accordingly, it is hard to imagine that an activist investor would wish to incentivize one of its board nominees to make the wrong analysis of the probability-weighted success of various alternative strategies open to the corporation. Nobody makes money from directors shutting their eyes.

Risk tolerances are a bit different, as they reflect individual investor preferences, and they may be affected by the investor's time horizon. An example might be helpful.

Consider a case in which directors are faced with a choice between Strategy A—implementing a leveraged stock buyback plan, which has a 100 percent chance of adding \$1 to the share price in the short term, and Strategy B—a long-term capex plan, that has a 60 percent chance of adding \$2 per share (on a net present value basis) to the market price two years from adoption. The immediate risk-adjusted value of the long-term capex alternative would be \$1.20, but whether this is actually more attractive to the board than the \$1 per share "sure thing" will depend on its collective risk tolerance. Interestingly, the board might have a lower risk tolerance than its shareholders for a simple reason: The board (and the company) has only one shot at achieving the desired result, with a 40 percent chance of not succeeding. If the board had two shots at getting it right, they would have only a 16 percent of getting nothing, a 48 percent chance of getting (on average) $1, and a 36 percent chance of getting (on average) $2. The more times the board has to roll the dice, the more likely it is to realize (on average) the risk adjusted value of $1.20. In other words, the more times the board can roll the dice, the more they reduce the 40 percent chance that they end up with zero.

What is interesting about this is that shareholders with a diversified portfolio may have more than one company in their portfolio facing similar odds—in effect, the shareholders get to roll the dice multiple times. Accordingly, one would think that shareholders, rather than pressing for the short-term payoff, would more typically be pressing for the riskier long-term payoff, which is clearly at odds with the cartoon scenario depicted above.[3] Again, there are two traditional explanations that can be employed to solve this conundrum.

Fans of activist shareholders will argue that management's risk tolerance is inappropriately high—that they are incentivized to seek to increase the option value of their control by extending the length of their control—effectively increasing their risk tolerance for long-term strategies (and possibly impairing their judgment of the probability-weighted success of long-term plans). In other words, management is improperly incentivized to think long-term "especially if because of poor performance and strategy [the option value of its control] is then out of the money."[4]

On the other side of the equation, there may be another dynamic at work that lowers the risk tolerances of short-term investors. If shareholders are going to trade out, on average, within nine months—in fact in 4.5 months on average after any given announcement—they have to judge not only whether management has made the correct probability weighting, but also whether the market will give management full credit for its choice *before* they trade out. Even the most dedicated efficient-market theorists will concede that it takes some time for all information about a particular strategic course to be filtered into and absorbed by the market. It seems reasonable to assume that the longer-term and riskier the strategy, the more time the market may need to absorb and judge.[5] If a board chooses Strategy B above (the option giving a 60 percent chance of a $2 return and 40 percent chance of zero return), and the market only gives $0.90 of credit for the choice in those first few months after the announcement, then the short-term shareholders will prefer the less risky Strategy A, yielding a 100 percent chance of a $1 return. So the risk tolerance of shareholders—particularly short-term shareholders—may be reduced by the inefficiencies of the market.

One could question why institutional holders would not simply hold their shares until the full $1.20 price increase was realized—everyone loves an undervalued stock, right? But regardless of whether you believe that investors have predetermined investment timeframes, there is another layer to the analysis that might cause diversified institutional shareholders, constantly on the lookout for the best value proposition, to prefer the less risky strategy.

To continue with the example above, assume that on the day the board makes its decision, the stock was at $5 per share. On the day after the board selects Strategy B, the price per share increases not to $6.20 but only to $5.90. In simplest terms, the shareholder is now holding a stock with a 60 percent upside opportunity of $1.10 (risk adjusted upside of $0.66) and a 40 percent downside risk of $0.90 (risk adjusted downside of $0.36). (This compares with our theoretical pre-decision profile of a risk-adjusted upside opportunity of $1 or $1.20 (depending on the strategy chosen) and zero downside risk.) In other words, the risk profile changes significantly, and, when compared to other opportunities in the market, may well push the institutional holder toward an immediate sale. Knowing this, and knowing that the market may take some time to give full value to the longer-term strategy, can only make diversified institutional shareholders—regardless of any fixed time horizon[6]—strong advocates for the lower risk alternative, which will allow them to capture the $1 gain immediately and then move on to greener pastures.

(Note also that market inefficiencies may build on themselves. A sale by investors at $5.90 may look as if the market is reacting negatively to the board's choice of the long-term strategy—the market likely taking it as a vote of non-confidence in the strategic choice, rather than a rebalancing of a portfolio after a partial realization of a potential gain—which will put downward pressure on the company's shares, making it even less likely that the company will get full credit in the short term for its choice of a long-term strategy.)

So, to sum up, no one will want to incentivize a director to make a poor analysis of probability-weighted outcomes, but there are differences in risk tolerances among investors—which may be driven in part by market inefficiencies (or simply by fears of market inefficiencies). An investor may wish to incentivize a director to adopt that investor's risk tolerance, which may or may not be similar to the market in general or to the "average" shareholder or to any theoretical "optimal" risk tolerance.

The question of whether there is an "optimal" risk tolerance in any situation—high or low—is left to greater minds. But it may be worth noting that risk tolerances may be the least easily quantifiable of all the factors discussed above and the most prone to situational influences. Accordingly, even those most partial to hard and fast rules may view prescribing a particular optimal risk tolerance for all situations as impossible and admit to the necessity of deferring to the business judgment of the board—the honest broker between management and activist.

Which brings us, finally, to golden leashes.

Lately, in the context of a difficult proxy battle, Agrium Inc. complained mightily about the "golden leashes" placed by JANA Partners on JANA's nominees for five (out of 12) Agrium board seats. These leashes consisted of payments to the JANA-nominated directors of a percentage of JANA's profits from its investment in Agrium. JANA questioned how incentivizing board members to maximize share price could create a conflict of interest for directors.[7]

So what was Agrium worried about?

First, they may have been worried that otherwise nominally independent directors cannot possibly be truly independent if they are getting paid by one particular shareholder with a particular point of view—regardless of the form of payment. That seems to be a fairly fundamental objection, and shareholders prior to voting will presumably need to satisfy themselves that the proposed directors are in fact qualified, independent businessmen of sound judgment, and not lackeys of the insurgent. This question will get asked regardless of whether the insurgent provides any separate compensation to its nominees. JANA, in response, would argue that in order to get high quality, independent nominees to step into a contentious situation, something more than the usual director's fee is appropriate and, in fact necessary. Again, absent misaligned risk tolerances, all investors should have the same interest in hiring directors best able to evaluate and correctly probability-weight the various alternatives open to the company. So, if you assume all investors have the exact same risk tolerance (and further assume the intellectual honesty of the nominees), paying certain directors more to do this job should not be an issue.

Sadly for those who love simplicity, assuming that all shareholders have the same risk tolerance is certain to be contra-factual. This may explain why Agrium seemed to be more agitated by the *form* of the payment than the mere *fact* of the payment. Here, the argument gets more interesting. It is one thing if the nominees simply get a flat fee for services rendered, regardless of how they are rendered; it is quite another if the nominees get a share of JANA's profits. Sharing JANA's profits raises the question rather directly as to whether the amount of the payment to be received by the nominees depends on the timeframe in which the shares will be sold by JANA, and, if the timeframe will determine the ultimate price realized, whether it is appropriate for an honest broker to have a cash incentive to adhere to a particular timeframe, which is outside of the nominees' control.[8] In other words, does the lack of control of the time of disposition mean that the nominees will be incentivized to adopt the risk tolerance of the insurgent?

To be fair, it did not appear that JANA had announced any specific timeframe for its exit, so at the time of nomination there would not seem to have been any attempt to influence the nominees on that basis.[9] On the other hand, JANA certainly had not handed over the disposition decision to its independent nominees—nor is it likely JANA could do so, having fiduciary duties to its own investors. Accordingly, there remained the specter of JANA tugging on that golden leash by announcing, for instance, that it would sell all its holdings within *x* months, or, more likely, that it thought strategy *x* would certainly lose money for the company, leaving the nominees to divine what sort of action would follow if strategy *x* were pursued. In short, the arrangement did seem to vest JANA with a means, however attenuated, of influencing the pocketbook of the nominees, and not just influencing their informed opinion.[10]

Courts will always scrutinize these arrangements to see if they will tend to make honest brokers any less honest. Any arrangement that potentially unhitches a director's financial incentives from the exercise of his or her best judgment is bound to be viewed skeptically. And even if rational economic theory would tell us that all shareholders with the same risk tolerance should have the same interest at heart, courts will always scrutinize closely the independence of nominees with any sort of economic incentive to act on behalf of their proponents—even if there is no standard available for judging whether one sort of risk tolerance is better than another.[11]

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Notes

1. *See* Sanford J. Grossman and Joseph E. Stiglitz, "On the Impossibility of Informationally Efficient Markets," 70 AM. ECON. REV. 393 (1980).

2. Getting enough information into the market about a particular long-term strategy seems to be less of an issue between the two camps—perhaps because it is fairly clearly management's responsibility—but, as discussed below, curing market inefficiencies by getting information to the market may be one of the most important ways to bridge the long-term/short-term gap. There may be cases in which confidentiality concerns prevent the proper explanation of a longer-term strategy, but in that case no one should be surprised if the market undervalues that long-term strategy.

3. Note, however, that anecdotally at least, activist hedge funds are often thought to have significantly less diversified portfolios than other institutional investors, given their focus on effecting change at select targets, as opposed to locking in relative returns across a broad portfolio. Accordingly, based on this metric alone—which is of course but one of many—the risk tolerance of activist hedge funds might rationally be closer to that of the target board than that of its fellow institutional investors.

4. Ronald J. Gilson and Jeffrey N. Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights," 113 COLUM. L. REV. (forthcoming May 2013).

5. A board's announcement that it is waiting for the business cycle to turn is certainly less likely to move the market than a merger proposal. However, as was evidenced in the great Airgas/Air Products battle, a board's decision to wait for the business cycle to turn may well be a better strategic choice than selling into a premium offer. In that situation, the board (including independent directors nominated by the bidder Airgas) rejected Airgas's premium offer of $70 per share, in the face of very strong shareholder sentiment in favor of a deal. Ten months after the bid was abandoned, the stock was trading at $75 per share. *See* Air Products and Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48 (2011).

6. It seems more likely that diversified institutional holders focus less on holding shares for any particular length of time and more on optimizing their potential returns at all times.

7. JANA went on to lose the proxy fight, and the story lost any further instructive value at that point. Other recent examples include Elliott Management's placing "golden leashes" on its short slate of nominees to the board of Hess Corporation, consisting of a payment for each percentage point by which Hess outperformed its peers at the end of a three-year period. Elliott's nominees waived their rights to these payments, saying they had become a distraction. In Carl Icahn's proxy battle with Forest Laboratories, Inc., he offered his nominee one percent of his profits over a certain share price (which was

about 30 percent over the market price at the time of the proxy fight).

8. One could also consider whether getting a share of JANA's profits would incentivize the nominees to adopt JANA's view of the correct probability-weighted value of the different alternatives. Again, there would not seem to be much reason for the nominees (or JANA) to shut their eyes to a better value proposition, so long as they judged that value proposition with the same risk tolerance (informed by the same perception of market inefficiencies).

9. The nominees would be entitled to a deemed profit on any shares still held by JANA after a three-year period, so effectively the scheme provided a strong incentive to maximize the share price on that date, to the extent JANA had not previously sold its shares. It should be noted that there are those who do not think three years is a "long-term" commitment to a corporation. For others, it seems almost impossible that it would take three years for the markets to efficiently value the prospects of a publicly traded company.

10. The Deal Professor, in his April 2, 2013 DealBook posting, raised a great point about both the JANA and Elliott versions of golden leashes: Both are upside-only payments. This creates an incentive that, taken to its extreme, might encourage a director to prefer a strategy with a 20 percent chance of making $10 and an 80 percent chance of losing $100 to a strategy with a 100 percent chance of making $2. Of course, as he also points out, this is also true to some extent of out-of-the-money options regularly awarded to management. Query whether upside-only incentives properly align the nominees' interests with activist funds that presumably have millions invested in the target stock and millions of potential downside. *See* Steven M. Davidoff, "Upping the Ante in a Play for a Stronger Board," N.Y. Times (Apr. 2, 2013), *http://dealbook.nytimes.com/2013/04/02/upping-the-ante-in-a-play-for-a-stronger-board/*.

11. Some might argue, reasonably, that a risk tolerance skewed in favor of short-term actions is preferable, as it reflects the reality that most shareholders are in fact short-term shareholders. Whether that is good policy is another question entirely. As is the question as to whether one could adopt measures to eliminate or reduce market imperfections that lead to delays in the market reflecting a proper risk-weighted valuation for target's shares (and that, as a result, skew risk tolerances).

SEC Confirms That Company Announcements of Key Information Via Social Media Can Be Regulation FD-Compliant

By Adé K. Heyliger

@SEC_News Issues Guidance on the Use of Social Media…#calmdown, not a #greenlight for companies to start tweeting material information.[1]

In a sign of the times, the US Securities and Exchange Commission (SEC) recently issued guidance for using social media channels to distribute material nonpublic information to the investing public in compliance with Regulation Fair Disclosure (Regulation FD). The guidance, which comes in the relatively unusual form of a Report of Investigation (Report) pursuant to Section 21(a)[2] of the Exchange Act of 1934, as amended (Exchange Act), clarifies that:

- Regulation FD applies to social media posts of material nonpublic information; and
- Companies may use social media channels such as Facebook and Twitter to announce key information in compliance with Regulation FD *provided that* investors have been alerted in advance about which social media channel will be used to disseminate such information in accordance with SEC guidance set forth in a 2008 interpretive release relating primarily to corporate Web site communications.[3]

The Report stems from an inquiry the Division of Enforcement launched last year into whether a post by Netflix, Inc. CEO Reed Hastings on his personal Facebook page may have violated Regulation FD and Section 13(a) of the Exchange Act.[4] Ultimately, the SEC determined not to pursue an enforcement action. However, because the investigation revealed market uncertainty regarding the applicability of Regulation FD to emerging technologies, the SEC issued the Report to provide guidance to issuers regarding how Regulation FD and the 2008 SEC Guidance on the Use of Company Web Sites (2008 Guidance)[5] apply to disclosures made through social media channels.

The good news is that the Report acknowledges that social media may be used by companies as an FD-compliant means of communicating with investors, and that the SEC does not seek to "[inhibit] corporate communication through evolving social media channels," but instead "supports companies seeking new ways to communicate and engage with shareholders and the market." As discussed below, however, companies seeking to embrace social media outlets as channels for communicating material nonpublic information to investors should first carefully review the SEC's 2008 Guidance and all company policies relating to Regulation FD compliance, insider trading, disclosure controls (including those relating to "mandatory" Form 8-K reporting[6]), and the protection of confidential information. For those companies that want to be "first out of the box" with social media communications, there now is a more defined path forward, albeit one with certain hurdles to leap that may not have been obvious at first blush if one simply were to read the title of the SEC press release accompanying the issuance of the Report—"SEC Says Social Media OK for Company Announcements if Investors Are Alerted."[7]

Social Media Disclosures Triggering Regulation FD

Regulation FD seeks to level the playing field in the market for corporate securities by

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prohibiting the selective disclosure of material nonpublic information to persons who are likely to trade on that information. Specifically, the regulation provides that when an issuer, or a person acting on its behalf,[8] selectively discloses material nonpublic information to any person enumerated in the regulation,[9] the issuer must distribute that same information—either prior to or simultaneously with the selective disclosure—in a manner reasonably designed to achieve effective broad and non-exclusionary distribution to the public. The Report makes clear that Regulation FD applies to social media posts in the same manner as any other Web-based corporate communication, emphasizing that

> [i]f an issuer makes a disclosure to an enumerated person, including to a broader group of recipients through a social media channel, the issuer must consider whether that disclosure implicates Regulation FD. This would include determining whether the disclosure includes material, nonpublic information. Further, if the issuer were to elect not to file a Form 8-K [to effect immediate, FD-compliant disclosure], the issuer would need to consider whether the information was being disseminated in a manner "reasonably designed to provide broad, non-exclusionary distribution of the information to the public." (Footnotes omitted)

Broad, Non-Exclusionary Distribution of Information to the Public

Although the 2008 Guidance was directed primarily at the use of corporate Web sites for the disclosure of material, nonpublic information (so-called "pull" technology), the SEC notes that today's evolving social media channels are extensions of the "push" technologies (for example, email alerts and RSS feeds) and "interactive" communication tools (for example, blogs) specifically identified in the 2008 Guidance. As such, the Report states, "the 2008 Guidance is equally applicable to current and evolving social media channels of corporate communication."

When information is deemed "public" for purposes of Regulation FD. In the 2008 Guidance, the SEC stated that to determine whether information posted on a Web site could be deemed "public" for FD purposes, such that a later selective disclosure of such information would not violate the regulation, a company must consider whether and when:

- A company Web site is a "recognized channel of distribution";
- Posting of information on a company Web site disseminates the information in a manner making it available to the securities marketplace in general; and
- There has been a reasonable waiting period for investors and the market to react to the posted information.[10]

As noted, the SEC stated in the Report that these same considerations should be applied to analysis of the dissemination of important corporate information via social media platforms.

"Recognized channel of distribution." The 2008 Guidance offered a non-exhaustive list of factors (discussed below) to be considered in evaluating whether a corporate Web site constitutes a recognized channel of distribution. Per the Report, the SEC expects issuers to "examine rigorously" the factors indicating whether a particular social media channel is a "recognized channel of distribution." It should be noted, however, that the central focus of the Report's inquiry is on one of those factors—whether the company has made investors, the market, and the media aware of the channels of distribution it expects to use, so that these parties know where to look for disclosures of material information. Thus, in addition to alerting investors to its use of a particular social media platform, a company seeking to establish that platform as a recognized channel of distribution will have to apply all of the other relevant factors described in the 2008 Guidance (as set forth above).

Providing appropriate notice to investors of the specific social media channels a company will use. Consistent with the 2008 Guidance, the SEC suggests in the Report that companies disclose on their corporate Web sites the specific social media channels they intend to use to disseminate material nonpublic information, so that investors can take the steps necessary to receive important disclosures (for example, subscribing, joining, registering, or reviewing that particular social media account). Companies also can include the same information in their SEC filings and press releases.

The Report strikes a particularly cautionary note on the personal social media sites of individuals employed by a public company, stating that, without adequate notice, these sites "would not ordinarily be assumed to be channels through which the company would disclose material corporate information." "This is true," according to the Report, "even if the individual in question has a large number of subscribers, friends, or other social media contacts, such that the information is likely to reach a broader audience over time."[11]

Interestingly, the Netflix saga came full circle on April 10, 2013, when the company seized on the SEC guidance contained in the Report by filing a Form 8-K to announce the social media channels through which it intends to disseminate company information that may be deemed to be material. Included in the list of five Netflix social media platforms is Reed Hastings' personal Facebook page, which was the subject of the Report's inquiry.[12]

Practical Implications

Despite the caption of the press release accompanying the Report—*SEC Says Social Media OK for Company Announcements if Investors Are Alerted*—the Report is certainly not a green light for companies to rush out immediately and disclose material nonpublic information via social media channels after merely notifying the markets of its intentions to do so. Behind the headline is the reality that companies considering whether to communicate with investors via social media will have to "examine rigorously" all of the other factors enumerated in the 2008 Guidance that must be weighed in evaluating whether a corporate Web site constitutes a recognized channel of distribution for Regulation FD purposes, and apply those factors to its chosen social media outlets. Among these factors is evidence of investor usage of a particular medium.

It is worth noting that, in the almost five years since the SEC released the 2008 Guidance, there does not appear to be a single domestic public company that has used its corporate Web site as the exclusive "recognized channel of distribution" for FD purposes, even though some have announced an intention to do so, and many have combined social media communications of important investor-related information with other FD-compliant tools such as a press release, Web cast, conference call, and/or Form 8-K filing (Item 801) or submission (Item 7.01 and/or Item 2.02).[13] This could be attributable to the fact that the 2008 Guidance lacks specificity as to what, other than a Form 8-K or press release, constitutes a "recognized [social media] channel."

Additionally, companies must be mindful that disclosures made via social media are subject to the antifraud provisions of the federal securities laws (as well as the anti-gun-jumping provisions of the Securities Act of 1933, as amended (Securities Act), and the proxy and tender offer rules under the Exchange Act, depending on the context in which disclosures are made). As a result, the company's existing disclosure controls and procedures should encompass communications made through social media posts by or on behalf of the company, and clearly prohibit the unauthorized disclosure of company-related information through such media. With this in mind, some companies may decide that the requirements for establishing a social media outlet as a recognized channel of distribution will be too difficult to administer, while others will embrace the opportunity to communicate with investors through these new and exciting means.

Practice Tips and Considerations[14]

The following are practice tips and considerations based on the 2008 Guidance for those companies seeking to establish social media channels as FD-compliant mechanisms for disclosing material nonpublic information to investors. Even for companies choosing *not* to use social media as their sole source of dissemination of corporate information, these tips will be useful going forward for those companies that decide to permit use of social media on a complementary basis with more traditional FD-compliant methods. We begin with a brief "refresher" on the 2008 Web site guidance, then turn to the application of this guidance to social media.

The 2008 Guidance—Factors a Company Must Consider in Determining Whether Its Web Site Is a Recognized Channel of Distribution and When Information Is "Disseminated"

- Whether and how companies let investors and the markets know that the company has a Web site and that they should look to the company's Web site for material information. For example, does the company include disclosure in its periodic reports (and in its press releases) of its Web site address, and routinely post important information on its Web site?

- Whether the company has made investors and the markets aware that it will post important information on its Web site, and whether it has a pattern or practice of posting such information on its Web site.

- Whether the company's Web site is designed to lead investors and the market efficiently to information about the company, including information specifically addressed to investors, whether the information is prominently disclosed on the Web site in the location known and routinely used for such disclosures, and whether the information is presented in a format readily accessible to the general public.

- The extent to which information posted on the Web site is regularly picked up by, and reported in, the market and readily available media, or the extent to which the company has advised newswires or the media about such information, along with the size and market following of the company involved. For example, in evaluating accessibility to the posted information, companies that are well-followed by the market and the media may know that the market and the media will pick up and further distribute the disclosures made on their Web sites. On the other hand, companies with less of a market following may need to take more affirmative steps so that investors and others know that information is or has been posted on the company's Web site, and that they should look at the company Web site for current information about the company.

- The steps the company has taken to make its Web site and the information accessible, including the use of free "push" technology, such as RSS feeds, or releases through other distribution channels, either to distribute such information widely or advise the market of its availability. The SEC does not believe that it is necessary that push technology be used in order for the information to be deemed adequately disseminated, although that may be one factor to consider in evaluating the accessibility to the information.

- Whether the company keeps the content of its Web site current and accurate.

- Whether the company uses other methods in addition to its Web site to disseminate the information and whether and to what extent those other methods are the predominant methods the company uses to disseminate information.

- The nature of the information.

Application of These Factors to Social Media

In applying the SEC's 2008 Guidance to a particular social media platform, with the aim of establishing that platform as a recognized channel of distribution and an FD-compliant means of disseminating information, companies may wish to consider adopting the following practices:

- Review all company policies relating to Regulation FD compliance, insider trading, disclosure controls and procedures, and the protection of confidential information, and revise as necessary or appropriate to cover the new platform. Distribute revised policies to directors, officers, and other employees and have them certify that they have read and understand the materials.

    - Ensure that the insider trading policy's "blackout" periods apply to social media communications, at least with respect to directors, officers, and personnel with access to material nonpublic company information.

    - Ensure that disclosure controls and procedures cover "informal" electronic disclosure made by or on behalf of the company that ordinarily are not filed with or furnished to the SEC.

- Institute training at all levels of the company (including the board and senior management) on the use of social media, and consider adopting a standalone social media policy that is fully integrated with the company's Regulation FD and insider trading policy or policies.

    - A social media policy should cover such matters as compliance with Regulation FD, permitted and prohibited employee use, use of social media by executive officers, attribution of materially misleading statements or omissions, and required approvals for communications of company information.

- Establish a particular account (for example, a separate Twitter account or Facebook page) to disseminate material company information and make sure that all material news releases are posted to that official account.

    - Note that using multiple social media outlets can present FD compliance concerns if, for example, material information is not posted simultaneously on all identified outlets—that is, if information is posted on one social media outlet in advance of others, investors subscribed to that particular outlet will have an informational advantage over investors who happen not to follow that outlet.

- Include references to the official account in all company press releases and SEC filings, and before the company begins using the new medium, announce that the company routinely intends to disseminate material company information via such account. For example:

    "The company intends to use its [insert official Twitter, Facebook other social media account] as a means of disclosing material nonpublic information and for complying with its disclosure obligations under Regulation FD. Accordingly, investors should monitor this account, in addition to following the company's press releases, SEC filings and public conference calls and webcasts."

- Know your investor demographics. Not all investors will be open to using subscription-based services, whether for privacy or cost reasons, or otherwise.

- Timely post information and ensure that information is current and accurate. Link such information to the company's IR Web page. Develop a regular practice of updating, deleting, or archiving content on the official social media account, in conjunction with the IR Web page and other investor-oriented areas of the company's Web site. This will help the company establish a recognized pattern or practice of posting information to its official social media account, and ensure appropriate vetting and the conformity of that information as disseminated through all "official" corporate communications vehicles.

- Take steps to increase the number of followers or subscribers, particularly media-related followers, to help ensure that posted material information is picked up and redistributed by the media.

- Monitor the number of subscriber/follower reposts of official company posts (for example, how frequently company tweets are retweeted) to help determine when the account has become a recognized channel of distribution.

- Take a "belt-and-suspenders" approach to disseminating material nonpublic information until the particular social media outlet has been established as a recognized channel of distribution—that is, use social media to supplement the dissemination of information to the public by other, more conventional or accepted means (for example, use Twitter to "tweet" highlights from a previously disseminated earnings release, including a link in the tweet to that release). Take measures to ensure that the supplemental social media post does not precede the public availability of the information via a Form 8-K or other FD-compliant means and that it goes no further than what's been said otherwise.

- Keep in mind that until the social media platform is established as a "recognized channel of distribution," its use presents a timing concern from an FD perspective—in other words, a social media post of material nonpublic information cannot precede the public availability of that information via an FD-compliant means (such as an 8-K).

- Also keep in mind, as discussed above, that some material events *must* be reported on Form 8-K.

The Applicability of the Antifraud Provisions of the Federal Securities Laws and Other Rules to Social Media Communications

Social media posts are analyzed the same way as any other company disclosure and thus, as noted above, are subject to the antifraud rules, as well as Section 5 of the Securities Act, the proxy and tender offer rules, and such other provisions as (for example) Section 13(d) of the Exchange Act.

Practice Tips:

- The SEC cautioned in the 2008 Guidance that, while blogs or forums can be informal and conversational in nature, statements made there by the company or company spokespersons will not be treated differently from other company statements when it comes to the antifraud provisions of the federal securities laws. The same caution should be applied to company or company spokesperson statements posted on other social media channels, such as Facebook and Twitter. The company should have controls in place to monitor statements by company spokespersons on social media outlets to make sure that such statements are not misleading.

    - Note that when posting to social media outlets with character or content limitations (for example, Twitter's 140-character limit), attempting to summarize material information within the confines of such restraints could present a risk of running afoul of the antifraud rules because of what is omitted. Moreover, these content limitations may force companies to truncate or omit the safe harbor provision in the Private Securities Litigation Reform Act (PSLRA).

Disclosure Controls and Procedures Should Cover Company Communications Made Via Social Media

Given the applicability of the federal antifraud rules and other provisions of the federal securities laws, including but certainly not limited to the mandatory line-item disclosure requirements of Form 8-K, a company's disclosure controls and procedures should be broad enough to monitor all social media communications made by or on behalf of the company for compliance not only with Regulation FD, but also with other securities law provisions that potentially give rise to disclosure and filing obligations.

Practice Tips:

- Review existing disclosure controls and procedures to ensure that they cover, or can be applied to, social media communications made by or on behalf of the company.

- Provide training to investor relations and communications personnel on complying with the SEC's rules concerning public dissemination of material information, and make them aware that the antifraud rules (and, potentially, other provisions of the federal securities laws), apply to communications made via social media.

- Have the disclosure committee or a subset of the committee (or functional equivalent) periodically review the company's social media channels to determine the type and scope of information being posted and whether the company is properly assessing the public dissemination factors discussed herein.

Notes

1. A little social media humor. Note that the title is exactly at the Twitter 140-character limit.

2. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, Release No. 34- 69279 (Apr. 2, 2013), available at: *http://www.sec.gov/litigation/investreport/34-69279.pdf*. Section 21(a) of the Exchange Act authorizes the SEC to investigate violations of the federal securities laws, and, in its discretion, "to publish information concerning any such violations." The Report is the second Section 21(a) report on Regulation FD; the first report involved an inquiry into Motorola, Inc. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc., Release No. 34-46898 (Nov. 25, 2002), available at: *http://www.sec.gov/litigation/investreport/34-46898.htm*.

3. Companies should keep in mind their existing Form 8-K disclosure obligations relating, for example, to the submission of historical earnings releases (Item 2.02), and disclosure of material impairments (Item 2.06), change in control (Item 5.01), and other material events that require the filing of a Form 8-K.

4. To our knowledge, the Netflix incident marked the first time the Division issued a Wells Notice based on a social media communication. Of course, there may have been prior situations in which a company did not—in contrast with Netflix—publicize its receipt of a Wells Notice relating to possible Regulation FD violations arising from such communications.

5. Commission Guidance on the Use of Company Web sites, Release No. 34-58288 (Aug. 7, 2008), available at: *http://www.sec.gov/rules/interp/2008/34-58288.pdf.*

6. *See* Endnote 3, *supra.*

7. *See* SEC Says Social Media OK for Company Announcements if Investors Are Alerted (Apr. 2, 2013), available at: *http://www.sec.gov/news/press/2013/2013-51.htm*.

8. For FD purposes, the following persons are deemed to be "acting on behalf of" a company:

- "Senior officials" of the company, meaning any director, executive officer, IR or PR officer, or person with similar functions; and
- Any other officer, employee, or agent of the company who regularly communicates with investors and/or securities professionals.

9. FD was adopted to address the selective disclosure of material nonpublic information to those persons whose trading on the basis of such information was reasonably foreseeable. Accordingly, it applies to communications with the following:

- Brokers or dealers and their associated persons;
- Investment advisers, certain institutional investment managers, and their associated persons;

- Investment companies, hedge funds, and affiliated persons; and
- Any holder of a company's securities under circumstances in which it is reasonably foreseeable that the person would purchase or sell those securities on the basis of the information.

10. Per the 2008 Guidance, the factors to consider as to whether there has been a reasonable waiting period for investors and the market to react to information posted via Web site include:

- The size and market following of the company;
- The extent to which investor-oriented information is regularly followed;
- The steps the company has taken to make investors and the market aware that it uses its Web site as a key source of important information about the company; and
- The nature and complexity of the information.

11. This statement may have been included in the Report in response to Mr. Hastings' argument in defense of his actions that "posting to over 200,000 people is very public." *See* "Weil Client Alert" by Christopher Garcia and Melanie Conray, Applying Securities Laws to Social Media Communications (Dec. 2012).

12. The Netflix 8-K, available at: *http://www.sec.gov/Archives/edgar/data/106528%0119312513149406/d519782d8k.htm*, also included the following statement:

> The SEC's Report of Investigation provided guidance to issuers such as Netflix regarding the use of social media to disclose material non-public information. In this regard, investors and others should note that we announce material financial information to our investors using our investor relations Web site (*http://ir.netflix.com*), SEC filings, press releases, public conference calls and Web casts. We use these channels as well as social media to communicate with our subscribers and the public about our company, our services and other issues. It is possible that the information we post on social media could be deemed to be material information. Therefore, in light of the SEC's guidance, we encourage investors, the media, and others interested in our company to review the information we post on the U.S. social media channels listed below. This list may be updated from time to time on Netflix's investor relations Web site.

13. Google issued an "advisory release" in April 2010 announcing that the company "intends to make future announcements regarding its financial performance exclusively through its investor relations Web site." A few other companies have reportedly emulated this practice. However, it does not appear that any company relies exclusively on its Web site as the sole mechanism for disseminating material information pursuant to the 2008 Guidance. Rather, these companies appear to use Web site disclosures as a supplement to information distributed through FD-compliant means.

14. *See also* "SEC Guidance on Use of Corporate Websites—Where Are We Four Years Later?" (Sept, 1, 2012) for the Course Handbook for Practicing Law Institute's 44th Annual Institute on Securities Regulation, co-authored by Weil Partners Catherine Dixon and P.J. Himelfarb, and Keir Gumbs.

Top Dozen Types of Apps for Boards (& Their Advisors)

By Broc Romanek

Now that most directors have iPads—oftentimes courtesy of one or more boards that they sit on—it is fair to say this device has become mainstream in the governance industry. Below are some apps that you may find helpful in either your capacity as a director or a corporate secretary (please share your favorite apps with me at *broc@naspp.com*):

1. **Corporate Governance Apps:** There are only a handful of apps that relate directly to governance. Corporate Board Member has its magazine available as an app (that is, CBM magazine). Deloitte has an "AC Resources" that includes its publications for audit committees. PwC does something similar with its "Board Center." There are a few apps that allow you to buy a set of the SEC's regulations—but in the clumsy format of the federal code. There really isn't much yet in the way of governance resources.

2. **Investor Relations Apps:** Although there are more investor relations apps than there are governance apps, the pickings still are pretty slim. Most are company-specific and contain the content typically found on a firm's IR Web page. Most of these are European companies but there are some US-based firms such as Wal-Mart, FirstEnergy and Newmont Mining. So far, the Deutsche Borse Group is the only company to create an app just for its annual report to shareholders (it has done so with its last two annual reports). This keeps with the tradition that the best IR Web sites out there belong to European companies.

   NIRI appears to have the only IR publication on iPad (IR Update), and the popular StockTwits and SeekingAlpha communities for investors only have iPhone apps (none for iPads yet).

3. **General News Apps:** The best bet for governance and IR news is through the mass media at this point. All the major publications have their own app (for example, WSJ has an app). Consider industry-relevant magazine subscriptions for your directors. Zinio has a good app for magazine subscriptions to supplement the iPad's newsstand. Kindle for iPad allows directors to sync their Kindle library across their devices, supplementing iBooks. For PDF documents, I use Adobe Reader or GoodReader for iPad.

   I use the Audible app for audio books, including WiFi download. The audio function of the Economist app is pretty neat—it reads the articles in a proper British accent. Flipboard is a popular app that allows you to "flip" through its social-networking feeds and other media organizations that have partnered with the company.

4. **Consents & E-Signature Apps:** Adobe Echosign allows the corporate secretary to send documents to officers and directors for electronic signatures.

5. **Meetings Apps**: Try the Cisco WebEx Meetings app to hold a meeting via the iPad.

6. **Expense-Tracking Apps:** One of the challenges for busy directors, particularly if they sit on multiple boards, is keeping track of expenses. Expense-tracking apps such as Concur can help manage the mess.

7. **Travel Apps:** As most directors travel quite a bit, an app such as Trip-It can be a lifesaver as you will not only have all your plans stored on your device, but you can receive

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text alerts if a plane is delayed or has a last-minute gate change. Kayak is a comparison app like TripIt. The major online travel agencies have apps: Expedia, Priceline, Travelocity, etc. So do all the major airlines, hotel chains and car rental agencies. Hipmunk has a very cool timeline display of flight options. I also use the app for the DFW Airport Valet; your principal airport may have its own app, also. GoGo Inflight Internet allows easy access to inflight WiFi.

I also love the apps that allow a user to arrange for alternative taxi services such as Uber (town cars in 15 major cities) and SideCar (only in a few cities right now, but it's cheaper than a cab and has Yelp-like ratings of the drivers).

8. **Task & Content Management Apps:** There are myriad content management apps ranging from those such as Accenture's Content Reader (allows collaboration on document review) to some that allow remote access to your PC or Mac (for example, LogMeIn). Copy2Contact lets you create a contact from text captured in any app.

9. **Drafting & Notes Apps:** Pages is the Apple word-processing app for iPad. I also use Documents to Go–Office Suite to edit Microsoft Office documents. There are some other apps that allow easy sync of created documents with Cloud services, for example, WriteUp and Good Docs'. Although it's not an app, consider providing directors with a Bluetooth keyboard, such as the Logitech Ultrathin Keyboard Cover. I use Scanner Pro for scanning, PrintCentralPro for printing (the free version is Print n Share).

10. **Walkie-Talkie Apps:** In a September 6, 2012 column, the New York Times reviewed a group of apps—Voxer, HeyTell, and Zello—that turn an iPhone into a walkie-talkie. This app might be something quite useful for corporate secretaries on the day of their annual shareholders' meeting.

11. **Dictation Apps:** For those directors whose eyesight may be poor, typing on an iPhone, or even an iPad, can be challenging. For those with Siri on their iPhone, speaking a text can be a wonderful thing. And for those with older iPhones (or who have turned Siri off), the free Dragon Dictation app is remarkably accurate (and Dragon Go functions much like Siri).

12. **Social Media App:** Many corporate secretaries, IROs, and directors are behind on using social media. There are apps for LinkedIn, Facebook, and Twitter. I use Tweetbot on the iPad. Some use UberSocial on the Blackberry.

Bonus: "Thumbs Up" App & More: Have a good board meeting? Open your "Bic Lighter" app and show your flame, just as you did at rock concerts in your youth. Or if the meeting was lousy, blow off some steam by breaking glass with the "Crack & Break" app. And the TuneIn app is invaluable to access, free of charge, countless Internet radio stations, many specializing in particular types of music. Finally, everyone has to have the free "Flashlight" app that turns your phone or iPad into a source of light.

Board Focus on Cyber Security: A Director's Perspective

By Betsy Atkins

In this new Internet age, business never stops. With the emergence of virtual, mobile, and cloud technologies, the traditional perimeters of business have disappeared, and the addition of these new technologies has forever changed how we live and work. As business leaders, we need to embrace these new technologies to improve productivity and, ultimately, share price. The policies governing how these new technologies are utilized, however, needs board-level attention to set and measure the thresholds of risk. Business leaders tend to underestimate risk if they haven't been affected by it. Risks are increasing in a global environment that operates 24/7, yet there is a stubborn insistence on touching the hot stove before believing it hurts.

Threats to assets come from a variety of sources and need to be addressed at the board level with a program that has both support and funding.

Risk Evaluation

What are the risks and where do they come from? There is a tendency, fueled by the media, to focus on technical exploits that are out "in the wild," as if the only risk of concern is from a zero-day exploit. The reality is much more mundane, and also much more complex. While it is certainly important to ensure that technical risks from outside the organization are mitigated, it is equally important to manage risk posed by insiders and third-party relationships. It doesn't matter if your assets were compromised by a sexy new exploit or by an employee losing a laptop with client data. The data is still compromised.

Betsy Atkins is the CEO of Baja Ventures, an independent venture capital firm, and Director of Chico's FAS, SunPower, and Polycom.

Know Your Cyber Risks

An organization's greatest threat is in not knowing its risks. Business functions that were traditionally performed on paper are migrating online, a move that necessitates a different approach to asset protection. A locked door may have protected sensitive paper files, but is of little use in protecting data that is stored online. Companies, under pressure to provide online services, may fail to perform an informed risk assessment that factors in technology concerns. The ability to quickly access a vast amount of data from any location leads to an increased risk of unauthorized access, thereby turning a technological advantage to a potentially serious disadvantage. Although business risks vary from company to company, some basic risk elements are universal:

- Theft of intellectual property;
- Fraud; and
- Sabotage.

Know Where Your Risks Originate

External Threats. To accommodate an increasingly mobile workforce, organizations provide many services online, **thereby making** it convenient for personnel to work **remotely**. This also makes it easier for undetected unauthorized access, however. In the virtual world, there is no security guard at the door checking credentials before permitting access.

Media attention is paid to the threat from malicious hackers who target any system that is vulnerable to the latest exploit. The real threat is more serious: Motivated attackers who are specifically targeting your organization and have the time and/or skill to succeed and evade detection. Known as an advanced persistent threat (APT), this is a serious risk that must be addressed.

The motivation for bored hackers may be to see if their exploits succeed—but the motivation behind APT attackers is to gain access to your data for long periods of time. Unlike amateurs, once they have gained access to your system, they won't be interested in bragging rights, so you may never know that your data was compromised.

Insider Threats and Risk Scenarios

It's easier to recognize threats from external sources because outsiders are not usually authorized to access internal information. It is much more difficult to gauge threats from internal people and to recognize characteristics of insiders who may compromise data, either through ignorance or by design.

Scenario 1: A new hire emails confidential data containing client information to a personal email account to work on from home. When discovered, the new hire claims not to have known that it was against company policy and that he or she had not been required to undergo information security training.

What are the risks and potential business impact for not ensuring every new hire receives information security training?

- Breach of contract—financial liability;

- Privacy breach—legal liability.

Scenario 2: A business unit decides to bring in a new contractor to assist during a busy season. Because of time constraints, the unit does not wait for a background check before allowing the contractor to start, and provides the contractor access to system resources.

What are the risks and potential business impact of not following the new hire process to completion?

- Allowing a criminal to gain access to the company's systems;

- Breach of contract—liability.

Scenario 3: An associate takes his laptop on vacation. He lets his family use the computer to read email. One of his children uses it to go to a number of gaming sites and message boards.

What are the risks and potential business impact of not restricting the use of a business computer to business purposes only?

- Malware could be loaded on the associate's laptop, infecting other machines when reconnected to the network.

- Confidential data could be stolen from the associate's laptop.

- Associate's user credentials could be stolen and used to breach the system at a later date.

Scenario 4: An associate has installed a Web cam and Skype on his computer for videoconferencing.

What are the risks and potential business impact of allowing associates to install videoconferencing technology?

- Potential for Web cam to be accessed remotely to spy on the associate;

- Compliance violation (lack of business record, cannot audit Skype use);

- Skype is not compliant with standards;

- Risk of peer-to-peer software spreading malware.

Risk Tolerance Must Be Defined at the Top

A clear articulation of the parameters of an organization's risk tolerance must be reviewed at the board level. Boards mitigate risks through reviewing appropriate internal policies that the organization will meet or exceed.

On the network and internet front, risks and network vulnerabilities are constantly shifting.

An effective Information security program needs to adapt to these changes. The biggest challenges for most companies are to discover what is actually on their network. Vulnerabilities are typically discovered at too slow a rate to manage or react to them—and many don't communicate what needs to be fixed very well.

The good news is that for network and Internet policies, many new automated network security monitoring technologies, such as Tenable's SecurityCenter Continuous View, can meet these challenges. These technologies can automate the audit, measurement, and reporting on security and compliance goals. It is important to look for technologies that can gather information and/or data in multiple ways, be "always on" or continuous, and are easily adaptable to emerging technologies.

Board and audit committees are well versed on SOX's Section 404 and internal controls. In this millennium, they must also be trained on a framework—such as ISO 27000—to evaluate whether cyber security of shareholders' assets is complete and robust.

How Boards Address Cyber Security Risk

For many boards today, cyber security is higher on the priority queue for risk oversight for audit committees and the full board than it was just a few years ago. Typically, the audit committee is the place where corporate security, cyber security, software, compliance, and vulnerability are managed. As part of the overall framework for risk management, audit committees consider the topic of security vulnerability on a regular basis. There is also the task of monitoring and overseeing the compliance program, including security standards that are evaluated and measured—for a variety of issues such as the data center—as part of the information technology/CIO function. Such oversight ensures that there is proper backup redundancy for the data center's physical security, from a hurricane power outage, for example, or other disruption in the continuity of operations.

There is a series of questions and reviews conducted by the audit committee that addresses risk management to ensure there have been no breaches. Most of the time, the security testing is done with advance notice, but it is actually a more accurate test if it is performed unannounced.

Audit committees tend to focus more on internal control risks, data center risks from a physical level (damage from flood and hurricane, for example), and then, as a lesser priority, the risk of the data center from a cyber-security view. This should change —cyber security risks warrant a greater look—particularly the protection of client records, intellectual property, and sensitive employee and customer information.

Conclusion

The overall security readiness of a company is an area on which boards are not as focused as they need to be. This is partly because when management ranks risks, it does not put cyber and security vulnerabilities high enough on the list.

Planning requires effort, but poor planning results in wasted resources. A proactive vulnerability management program that addresses specific business needs will go a long way toward providing real value to an organization.

A "Roadmap" to Accrual & Disclosure Requirements Under ASC 450

By Jeffrey Stein, Matthew Bozzelli, and Jamie Stainback

Among the categories of information requiring disclosure by public companies, "contingencies" is one of the more sensitive, because in addition to regulatory scrutiny, an organization may also be closely examined by analysts and investors. Disclosure of pending lawsuits and government investigations has the potential to affect an underlying proceeding, because adversaries may attempt to discern a company's outlook and strategy from the disclosure. Given the nature of high-stakes litigation, aggressive government enforcement initiatives, and the large loss contingency charges recorded during the financial crisis, concern over a company's contingencies disclosures continues to grow.

The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) have focused on how public companies disclose their loss contingencies and have explored the possibility of requiring additional contingencies disclosure. In this article, we provide a helpful guide or roadmap to the basic tenets of a company's obligation to accrue for and disclose loss contingencies. This roadmap focuses on the requirements under the accounting literature that often drive the most sensitive disclosures—FASB Accounting Standards Codification Topic 450 (ASC 450), formerly Financial Accounting Standards No. 5.

We acknowledge that the determination of whether a company is required to record an accrual or make disclosure of a loss contingency in the notes to its financial statements is an accounting matter, which must be made by the company and its independent auditors. Our roadmap is intended to provide a basic overview of applicable requirements for others who may be involved in the financial reporting process, such as company attorneys, senior management and members of the audit committee.

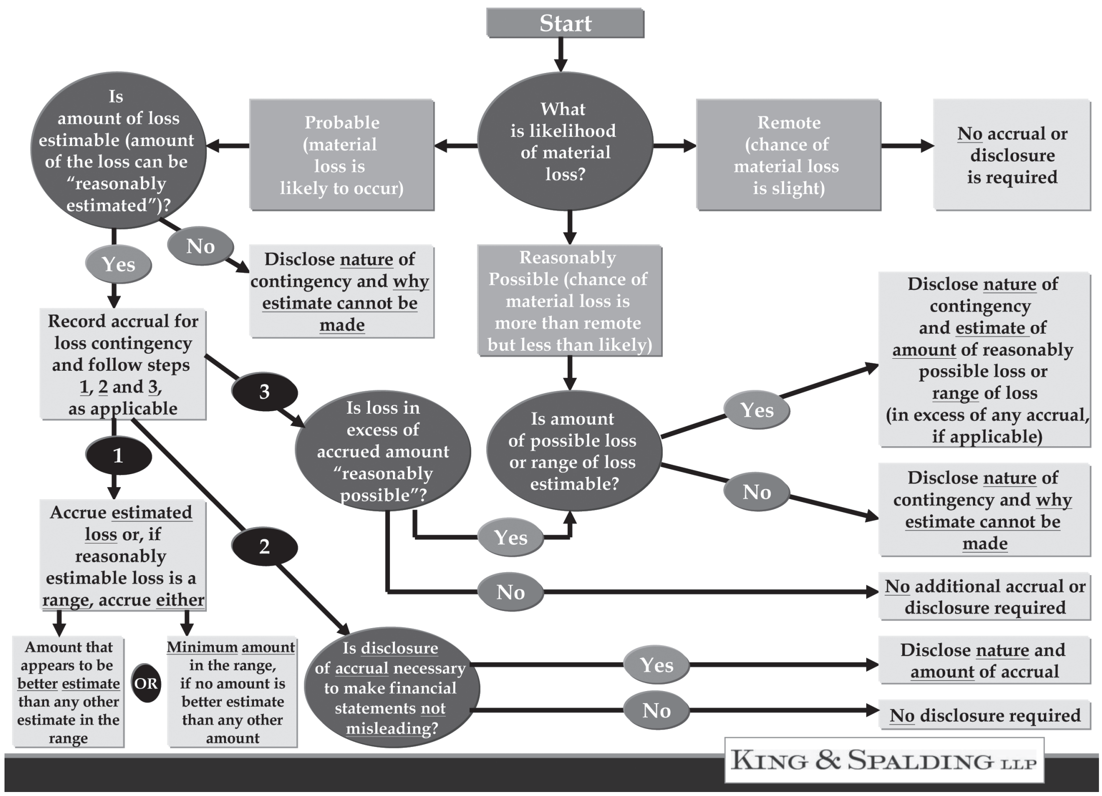
Overview

Public companies are required to disclose information about contingencies, such as litigation and governmental proceedings, in several areas of their periodic reports. For example, Item 103 of Regulation S-K requires disclosure about pending legal proceedings, while Item 303 of Regulation S-K requires that a company describe (in its Management's Discussion and Analysis) certain types of "trends and uncertainties" as well as items that may affect its liquidity. However, as a practical matter, the requirements under ASC 450—which could require the accrual of a charge for a contingency or the disclosure of a contingency in the notes to the financial statements—often drive the most sensitive disclosures.

ASC 450 defines a "contingency" as an existing condition, situation or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.[1] We have developed a roadmap reference chart (*see* Figure 1) to illustrate the process for determining whether a company (a) is required to record an accrual for a loss contingency, (b) is required to make disclosure about a loss contingency, or (c) may proceed with neither an accrual nor disclosure of the matter. The following description walks through this roadmap.

 Jeffrey Stein is a Partner, Matthew Bozzelli is Counsel, and Jamie Stainback is an Associate of King & Spalding LLP.

Figure 1. Roadmap of Accrual and Disclosure of Loss Contingencies Under ASC 450



Assessing the Likelihood of a Material Loss

The analysis under ASC 450 begins with a determination of the likelihood that the company will incur a material[2] loss, with there being three ranges of "likelihood"—remote, reasonably possible and probable.

- A material loss is "remote" if the chance of the future event is *slight*.
- A material loss is "probable" if the future event is *likely* to occur.
- A material loss is "reasonably possible" if the likelihood falls in the range between being remote and probable.

If the Likelihood of a Material Loss Is Remote

If the likelihood of a material loss is *remote*, there is no requirement for the company either to record an accrual or make disclosure of the contingency under ASC 450.

In 2010, the FASB proposed amendments to ASC 450 that would have required disclosure of remote contingencies if the potential impact is severe (for example, contingencies that might have disrupted the normal functioning of the company); these amendments, however, were not ultimately adopted in the wake of strong criticism of the proposal. Nevertheless, some companies may choose to disclose loss contingencies they consider to be remote. In this case, a company should consider disclosing that such pending matters are considered to have a remote likelihood of a material loss.

Illustration. A company with net assets of $2 billion is the subject of a *qui tam* complaint, alleging false claims of $300 million, which could be trebled if determined adversely. The company has concluded that there is a remote likelihood of a material loss, but provides detailed disclosure about the case. The company also discloses that it believes it has defenses to all the allegations in the case and indicates that it may disclose contingencies for which it believes the likelihood of a material loss is remote.

If the Likelihood of a Material Loss Is Probable

If the likelihood of a material loss is *probable*, then the company must determine whether the amount of the loss is reasonably estimable or not reasonably estimable.

If the amount of the loss is *reasonably estimable,* then the company is required to make an accrual for the loss contingency. The company is required to accrue either (a) the company's estimate of the loss, or (b) if the reasonably estimable loss is a range, then it must accrue either: (i) the amount within the range that appears to be the better estimate than any other amount in the range or (ii) the minimum amount in the range, if there is no amount in the range that is a better estimate than any other amount.

A company making an accrual is generally not required to disclose either that it has made the accrual or the amount accrued, except that it is required to disclose the nature and amount of the accrual if necessary to make the financial statements not misleading. As a practical matter, large or unusual accruals are often disclosed.

Illustration. A company has been the subject of a multiyear government investigation and has made disclosure of the investigation for several quarters although it has recorded no accrual. Now the company has reached an agreement in principle to settle the matter for an amount that is material to its results of operations, financial condition, and cash flows. The company records an accrual and also discloses the amount of the accrual.

If the amount of the loss is *not reasonably estimable*, then the company is not required (or permitted) to record an accrual for the contingency. Instead, it is required to disclose the nature of the contingency, and describe why it is unable to estimate the amount of the loss.[3]

If the Likelihood of a Material Loss Is "Reasonably Possible"—Meaning More Likely Than Remote, But Less Likely Than Probable

ASC 450 provides definitions for the terms "remote" and "probable," but the term "reasonably possible" is defined only as a likelihood that is more likely than remote, but less likely than probable. Because a loss contingency that is reasonably possible is, by definition, not probable, the company does not make an accrual for the contingency, but instead is required to make disclosure about the contingency.

In determining the disclosure that is required for a reasonably possible loss, the company must first consider whether or not the amount of the reasonably possible loss (or range of loss) is *estimable*. If the amount of the reasonably possible loss is *estimable*, then the company must disclose the nature of the contingency and also provide its estimate of the amount or range of loss.

Illustration. A company is involved in a lawsuit with a fixed (estimable) amount of damages. The company denies liability and believes that an unfavorable verdict is not probable but is reasonably possible. Because the loss contingency is reasonably possible, but not probable, the company does not make an accrual for the contingency, but is required to disclose the nature of the contingency and an estimate of any amount of loss that is reasonably possible.

If the company *cannot estimate* the amount of the reasonably possible loss, then it must disclose the nature of the contingency and describe why it is unable to estimate the amount of the loss.

Illustration. A company may be unable to make an estimate of a reasonably possible loss contingency for a pending lawsuit because (a) the matter is at an early stage, (b) the matter involves unresolved questions of fact, or (c) the matter involves novel types of claims or unresolved questions of law.

In the wake of the financial crisis in which many financial institutions took large write-offs, the staff of the SEC began to review companies' previous disclosure of contingencies to determine whether the companies had appropriately warned the market of reasonably possible contingent losses. In many instances, the staff found that companies had recorded large write-offs for matters that had not been the subject of previous disclosure (meaning that the contingency had gone from remote to probable, with no intervening disclosure of a reasonably possible loss). As a result of this focus, the staff of the SEC has recently issued comments on periodic reports that call for additional disclosure about reasonably possible losses.

In the SEC staff's comments under ASC 450, it has emphasized that:

- If companies are unable to estimate the amount or range of reasonably possible losses, they must provide disclosure about the contingency that allows users of the financial statements to evaluate the magnitude of the matter;

- As legal proceedings continue and approach resolution, the company should disclose additional quantitative information about the matter; and

- Even after a company has recorded a loss accrual, it must continue to consider whether there are reasonably possible losses in excess of the amount of the accrual (in which case disclosure may be required).

Treatment of Unasserted Claims

While the roadmap covers asserted claims or pending proceedings, ASC 450 uses similar constructs to deal with unasserted claims. A company is not required to make disclosure with respect to an unasserted claim if there is no manifestation by a potential claimant of an awareness of a possible claim, unless assertion of the claim is probable and there is a reasonable possibility that the outcome will be unfavorable.

Illustration. A company might be required to disclose the possibility of claims being asserted if: (a) the company becomes aware that it has sold defective products that have recently caused a series of deaths or critical injuries, but these deaths and injuries are not yet known to the general public, or (b) the company becomes aware that it has infringed upon a competitor's intellectual property and believes the competitor is likely to become aware of the infringement.

Notes

1. Although ASC 450 covers both gain contingencies and loss contingencies, in this article we only consider loss contingencies because they typically represent the more difficult contingency disclosures for public companies.

2. By its terms, the provisions of ASC 450 need not be applied to immaterial items. For purposes of ASC 450, materiality is determined under SAB 99, which discourages overreliance on quantitative thresholds in determining materiality and sets forth a nonexclusive list of qualitative factors that might cause a relatively small amount to be deemed material. With respect to Regulation S-K Item 103 (legal proceedings) and Item 303 (MD&A disclosure of uncertainties), materiality is determined using different standards developed under the securities laws.

3. One common question with respect to the ASC 450 analysis concerns the treatment of legal fees and expenses associated with the underlying loss contingency. In our experience, while a proceeding or investigation is pending, a company ordinarily records quarterly charges for legal fees and expenses on an ongoing basis (in the absence of an accrual for the matter itself).

Wolters Kluwer
Law & Business

Aspen Publishers
The Corporate Governance Advisor
Distribution Center
7201 McKinney Circle
Frederick, MD 21704

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July/August 9900529039