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Weil Briefing:
SEC Disclosure and Corporate Governance

December 30, 2009

Challenges of the 2010 10-K and Proxy Season

In approaching the upcoming 10-K and proxy season, public companies face new challenges stemming from the political, regulatory and investor response to the economic and financial upheavals of 2009. These challenges center around three themes: risk (and how it is managed), compensation (including its tie to risk) and whether the board has the qualifications, leadership and resources necessary, in light of current circumstances, to oversee risk management and compensation and to set the company's long-term strategic course.

In 2010, the "routine" annual meeting will largely be a thing of the past. The elimination of broker discretionary voting in uncontested director elections will magnify the impact of the majority voting standards adopted by many companies, giving institutional shareholders (and their proxy advisory firms) greater power than ever before in determining who serves on the board. This shift in power will be even more pronounced in 2011 and beyond if the Securities and Exchange Commission (the "SEC") moves forward as expected with some form of proxy access rules and Congress enacts legislation mandating majority voting and "say on pay." In addition, companies can expect more shareholder proposals, due in part to the SEC staff's recently expanded view of what constitutes a "policy issue" appropriate for a shareholder vote. In this volatile environment, effective communication with shareholders, whether directly or through the company's SEC documents, website and other media, presents another challenge.

Amendments to the proxy rules adopted just in time for this season not only impose new requirements but also provide a new forum for companies to make their case to investors about how they address risk, compensation, leadership and other aspects of governance. Although the SEC has said that the amendments are aimed at transparency and not at steering behavior, the process of responding to new disclosure requirements may lead a board and management to reassess and possibly refine their substantive approach to these issues.

In this briefing, we highlight what we see as the key areas for board and management focus for the 2010 season and suggest practical steps to address them:

- Governance challenges, including board composition, board leadership and the board's oversight role in risk management and compensation,
- Compensation-related challenges, including risk analysis and controls,
- Challenges relating to proxy solicitation and shareholder communications,
- Financial reporting challenges, and
- Challenges of the more aggressive enforcement environment.

We also note significant legislative and regulatory developments in these areas on the horizon.

I. Governance Challenges

On December 16, 2009, the SEC amended its rules to "help shareholders make more informed voting and investment decisions" by requiring significantly broadened disclosures about corporate governance and compensation matters.[1] We discuss the new disclosure requirements regarding corporate governance in this Part I, and those regarding compensation in **Part II.B** below.

- ***Effectiveness:*** According to transition guidance,[2] a company whose fiscal year ends on or after December 20, 2009 must comply with the new requirements in its upcoming Form 10-K and proxy statement if either or both documents are to be filed on or after February 28, 2010. Among other elements of the guidance:
  - Where a calendar-year company plans to file a preliminary proxy statement before February 28, 2010, but does not expect to file the definitive version until February 28, 2010 or later, the preliminary proxy statement must comply with the new rules.
  - However, a reporting company whose 2009 fiscal year ended before December 20 will *not* be required to comply with the new rules in any registration statement filed before the due date for its fiscal year 2010 Form 10-K.
  - All companies, regardless of fiscal year end, must report on Form 8-K the results of votes taken at annual and special meetings held on or after February 28, 2010. (See **Part III.B** below.)

A. Providing More Information About Directors and Nominees

The following new disclosure requirements are intended to provide investors with information important to the evaluation of an individual's "competence and character" and whether he or she is an appropriate choice to serve on a particular company's board. Additional background information about executive officers is also now required.

(1) Qualifications and Experience

As amended, Item 401 of Regulation S-K expands the required disclosures to include, for each director and nominee, the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director of the company. Previously, the rules only required disclosure of the minimum qualifications to be a nominee and brief biographical information.

This new disclosure appears to require a justification, in some sense, of the board service of each nominee and continuing director *(e.g., why was the person selected as a director?)*, and also, in some respects, gets to what the board views as the "fit" between the individual's service and the board's needs.[3] Note that, unchanged by the amendments, Item 407(c)(2)(v) of Regulation S-K continues to require disclosure of the specific minimum qualifications, qualities or skills required by the nominating committee for a nominee.

- ***Actions to Take***: The nominating committee, the board and the company will need to consider carefully how to describe the qualifications of each director and nominee, including in relation to the needs of the company and the board. Disclosure requirements aside, we recommend that the nominating committee review annually with the board the composition of the board as a whole, including the balance of independence, business specialization, technical skills, diversity and other desired qualities that the directors bring to the board. (For more on diversity, see **Subpart B** below.) Company counsel should begin a dialogue with the nominating committee chair early in each calendar year. As a starting point, the nominating committee chair and company counsel should consider requesting updated CVs from each of the directors (some companies may choose to include additional questions in the D&O questionnaire). Companies should begin drafting this section of the proxy statement early since each director will likely take a keen interest and may have comments.

(2) Other Directorships and Legal Proceedings

As amended, Item 401 of Regulation S-K requires disclosure of other directorships held by each director or nominee at any public company during the previous five years, rather than only current directorships. In addition, the amendments extend from five to ten years the disclosure of legal proceedings involving directors, director nominees *and executive officers*. The range of legal proceedings has been expanded to include: (1) judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity; (2) judicial or administrative proceedings based on violation of the federal or state securities, commodities, banking or insurance laws or regulations or any settlement thereof; and (3) any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization. Settlement of private litigation is *not* required to be disclosed.

- ***Actions to Take:*** Company counsel should revise D&O questionnaires to reflect these changes. Directors and executive officers should be made aware that additional background information about them may need to be disclosed.

B. Explaining Whether and How Diversity Factors into Nominations

As amended, Item 407(c) of Regulation S-K requires disclosure of whether and, if so, how the nominating committee considers diversity in identifying nominees for director. If the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, the new rules require disclosure of how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy. The SEC has not imposed a definition of "diversity," noting that some companies may see diversity as encompassing differences of viewpoint, professional and educational background and similar individual qualities and attributes, while others may focus on characteristics such as race, gender and national origin.

- ***Actions to Take****:* Companies need to develop the basis for this disclosure, which was not among the new requirements proposed in July 2009. Company counsel should bring this item to the attention of the board and work with the nominating committee to provide responsive disclosure.

C. Justifying the Board's Leadership Structure

As amended, Item 407 of Regulation S-K requires disclosure about the board's leadership structure and why the company believes it is the best structure for the company. Companies will have to disclose whether and why they have chosen to combine or separate the CEO and board chair positions. Where these positions are combined, the amendments require the company to disclose whether and why the company has a lead independent director and the specific role the lead independent director plays in the leadership of the company.

- ***Actions to Take***: At companies having a combined CEO/Chairman, boards should review the justification for the combined position. Many companies have already publicly taken a position on this issue in response to shareholders' Rule 14a-8 proposals to separate these positions. Companies that have designated a lead independent director may want to consider developing a position statement for the role (which could be included in the company's corporate governance guidelines or principles) that they can point to and rely on in their disclosures concerning the role.

D. Describing the Board's Role in the Oversight of Risk Management

As amended, Item 407 of Regulation S-K requires disclosure about the board's role in the oversight of risk management and the effect, if any, that this has had on the company's leadership structure. This requirement is intended to provide investors with an understanding of how the board administers its oversight responsibilities, such as through the entire board, the audit committee, a separate risk committee or complementary roles performed by one or more committees and the board.

In the adopting release, the SEC explained that the disclosure requirement is aimed at illuminating how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company, such as credit risk, liquidity risk and operational risk. The SEC suggested that, where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee, or how the board or committee otherwise receives information from these individuals.

- ***Actions to Take***: Companies may wish to review their risk management philosophies, policies and processes in light of the experiences of 2009 and the heightened scrutiny that risk management and its oversight will receive in 2010 as a result of the new rules. We recommend that boards focus on three key responsibilities:
  - *Understanding the risks facing the company as a function of strategy:* Most fundamentally, all members of the board need to have an understanding of the risks associated with the company's business and strategy so that they can make effective decisions. This should include an understanding of – and agreement about – the amount of risk that the company is willing to take on and manage for strategic advantage ("risk appetite").
  - *Providing oversight of the processes put in place to identify and manage risk:* The board must assure itself that the management team is focused on identifying and managing risk

and has instituted effective processes and systems to assist in these efforts. Risk management processes must equate with risk appetite: the more risk that is associated with a strategy, the more rigorous the risk management processes must be. Oversight may be handled in whole or in part by a board committee. Note that, although audit committees of New York Stock Exchange ("NYSE")-listed companies are required to "discuss policies with respect to risk assessment and risk management,"[4] they need *not* be solely responsible for risk management oversight. In certain industries – usually those that are highly regulated – a specialized risk committee may be established to oversee the management of regulated areas of risk.

- *Managing certain risks that only the board is positioned to manage:* The board needs to manage the risks that are associated with the board's governance and delegation decisions, including decisions about compensation. (See **Part II.A** below). Boards should assess their own structures and processes to ensure they have the capacity and resources to bring objective judgment to bear on the matters that come before them. They should also assess the processes that they use to identify matters for board attention, and the associated flow of information to the board.

E. Implementing a Change in NYSE Governance Standards

A number of changes to the NYSE's corporate governance listing standards (most representing a liberalization of reporting requirements) become effective on January 1, 2010.[5] The one significant change is an expansion of the requirement to promptly notify the NYSE after any executive officer becomes aware of *any* non-compliance with NYSE corporate governance listing standards, *not just material* non-compliance as currently required.

- ***Actions to Take:*** Companies should review their disclosure controls and procedures, revise as appropriate and provide training to ensure that all executive officers are aware of the corporate governance requirements of the NYSE listing standards (Section 303A) so that the company can make timely notification to the NYSE of any non-compliance (material or non-material).

II. Compensation-Related Challenges

The 2010 proxy season brings continued demands by investors for executive pay to be linked to performance, as well as new SEC compensation disclosure rules that put the spotlight on the relationship between employee-wide compensation and risk. These new rules will become effective on the timetable described in **Part I** above.

A. Incorporating Risk Analysis

In 2010, compensation committees will remain in the hot seat. Their decisions will receive intense shareholder (and for TARP participants, U.S. government) scrutiny, fueled by an uncertain economic outlook, sustained media attention on executive compensation, legislative initiatives intended to make boards more accountable to shareholders and to curb inappropriate compensation, heightened compensation-related standards of proxy advisory firms, increased shareholder activism and political and populist concerns about the level of executive compensation in relation to the pay of the average worker. This scrutiny will include the information companies disclose in response to the new compensation disclosure rules (see **Subpart B** below).

In addition to the already difficult tasks of "right-sizing" compensation and incentives, the compensation committee needs to incorporate risk analysis and related controls into the company's compensation policies and practices. Thought-provoking analysis of the relationship between risk-taking and incentive compensation can be found in the Federal Reserve's recently proposed guidance for banking organizations.[6] The Fed's guidance is based on the following three principles, developed through a lens of "safety and soundness:"

- Incentive compensation arrangements should not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk,
- They should be compatible with effective controls and risk management, and
- They should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

In the Fed's view, these principles should be applied not only to arrangements for senior executives but also to those for other employees who, either individually or as part of a group, may expose the organization to "material amounts of risk." While acknowledging that arrangements can be tailored to an organization's particular business model, risk tolerance, size and complexity, the Fed's overall watchword is "balance." Incentive arrangements should be balanced so that they do not give an employee incentives to increase short-term revenue or profit (especially if closely tied to the business generated by the employee himself) without regard to the full range and time horizon of risks and risk outcomes from the employee's activities. The Fed believes this requires strong controls, including the involvement in design and monitoring of highly-qualified risk-management personnel (whose own incentives should be structured to preserve the independence of their perspectives), and, above all, active oversight by a compensation committee reporting to the full board.

- ***Actions to Take**:* Compensation committees should:
  - Prompted by the new disclosure rules and the Fed's proposed guidance, evaluate compensation policies and programs *for all employees* so as to be reasonably assured that they do not incentivize the taking of unnecessary and excessive risks that could threaten the value of the company.
  - Consider implementing a "hold until retirement" equity policy, bonus/malus system (*e.g.*, where annual bonuses are held in escrow and can be reduced retroactively in case of losses in future years) and/or compensation recapture (or "clawback") policy in order to mitigate excessive risk-taking by executives and to align their interests better with those of other stockholders.
  - Review and, as appropriate, oversee the establishment or refinement of controls aimed at ensuring that incentive arrangements are functioning as intended with regard to risk.
  - Use a compensation consultant that is hired by, and reports directly to, the committee and is independent of management.
  - Continue to use analytical tools, such as tally sheets of all elements of compensation, wealth accumulation analyses, "walk-away" numbers and internal pay equity studies, to assist in evaluating and setting executive compensation.
  - Be aware of the "hot button" issues of investors and proxy voting advisors regarding compensation practices such as performance targets, golden parachutes and tax gross-ups (see **Part III.F** below).
  - Participate actively in the preparation of the Compensation Discussion and Analysis ("CD&A") and decisions about and, if necessary, preparation of the new risk-oriented compensation disclosure relating to all employees generally.

B. Tackling New Compensation Disclosure Requirements

The following new disclosure requirements are intended to provide investors with information about two categories of incentives: those that may encourage employees, regardless of where placed in the company's operations, to engage in inappropriate or excessive risk-taking behavior, and those that might lead compensation consultants to the board "to cater, to some degree, to management preferences." The new requirements are also intended to provide investors with a better understanding of compensation committee decisions by requiring tabular disclosure of the full grant date fair value of equity awards made to named executive officers ("NEOs") and directors, rather than only the amount expensed during a year for financial reporting purposes (as under the former rules).

(1) Compensation Policies and Practices As Related to Risk Management

As amended, Item 402 of Regulation S-K requires narrative disclosure about the company's overall compensation policies or practices *for all employees generally*, not just executive officers, "if the compensation policies and practices create risks that are *reasonably likely* to have a material adverse effect on the company." In the adopting release, the SEC argued that companies are already familiar with this disclosure threshold because it is used in the Management's Discussion and Analysis (Item 303 of Regulation S-K), which calls for risk-oriented disclosure of known trends and uncertainties that are material to the company's financial position and/or results of operations (or reasonably likely to have a material effect in the future). In assessing whether disclosure is required, companies may take into account controls and other elements that may mitigate the probability or potential impact of compensation policies and practices that might otherwise create a disclosure-triggering level of risk.

- ***Two important points:*** First, the new disclosure is *not* to be a part of the CD&A. Second, a company will *not* be required to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

New Item 402(s) presents a non-exhaustive list of situations where, in the SEC's view, employee compensation policies and practices may have the potential to pose material risks to a company, and therefore must be analyzed with a view toward possible disclosure. These "red flags" exist where a business unit (1) carries a significant portion of the company's risk profile; (2) has compensation structured significantly differently from other units; (3) is significantly more profitable than other units; (4) has compensation expense representing a significant percentage of its revenues; or (5) has a compensation scheme that varies significantly from the overall risk and reward structure of the company (*e.g.*, when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time).

Disclosure is only required if, after analysis, management concludes that one or more features of the company's compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. In the event disclosure is required, the SEC expects the company to take a "principles-based" approach and consider six non-exclusive "illustrative examples" of issues that may need to be addressed (much like the 15 elements governing analysis and discussion of executive compensation in the CD&A, as set forth in Item 402(b)):

- The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives created by these policies and practices;
- The company's risk assessment or incentive considerations, if any, in structuring compensation policies and practices or in awarding and paying compensation;
- How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short- and the long-term, such as through provisions for clawbacks or minimum equity holding periods;
- The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile;
- Material adjustments the company has made to its compensation policies and practices due to changes in its risk profile; and
- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.

- ***Actions to Take*:** In order to address these new requirements, companies will need to analyze the relationship between employee-wide compensation policies and practices and company risk, focusing in particular on whether any "red flags" exist and, if so, making a detailed risk assessment of those situations. We expect that a number of companies, unaccustomed to evaluating non-executive compensation from a risk management perspective, may need to seek advice from outside experts to address these matters critically. All companies should continue to consider the risk aspect of the incentives provided executives – particularly NEOs – and discuss and analyze risk-related issues in the CD&A where material.

(2) Fees Paid to Compensation Consultants and Potential Conflicts

As amended, Item 407(e) of Regulation S-K requires new disclosures about fees paid to and services provided by compensation consultants and their affiliates if the consultants provide consulting services related to director or executive compensation and also provide other services to the company.

If either the board or compensation committee has engaged its own consultant to provide advice or recommendations on the amount or form of executive or director compensation, and this consultant or its affiliate provided other services to the company in an amount valued in excess of $120,000 during the company's last fiscal year, the company is required to disclose:

- The aggregate fees paid for advising on the amount or form of executive and director compensation and the amount paid for all additional services;
- Whether the decision to engage the consultant or its affiliates for such additional services to the company was made by or recommended by management; and
- Whether the board or compensation committee approved the other services provided to the company.

If the board or compensation committee has not engaged its own compensation consultant, but a consultant which provided executive or director compensation consulting services to the company also provided other services to the company in an amount valued in excess of $120,000, the company is required to disclose the aggregate fees paid for advising on the amount or form of executive or director compensation and for all additional services.

Disclosure of fees paid to other compensation consultants retained by the company is *not* required if the board has retained its own consultant that reports to the board. The SEC also adopted exceptions where (1) the compensation consultant's only role in determining the amount of executive compensation is in connection with consulting on broad-based plans that do not discriminate in favor of executive officers or directors, or (2) the consultant's services are limited to providing non-customized information to the company such as surveys.[7]

- ***Actions to Take*:** Companies should review the services provided by compensation consultants and the company's existing policies and practices regarding the retention of compensation consultants and, in particular, the independence of consultants retained to advise the compensation committee. Companies will need to update their disclosure controls and procedures for these changes. In any event, best practices dictate that compensation committee members be aware of and approve of all services to the company provided by consultants on whose advice they rely.

(3) Valuation of Equity Awards

As amended, Item 402 of Regulation S-K requires disclosure in the Summary Compensation Table and Director Compensation Table of the aggregate grant date fair value of stock option awards made during the year, computed in accordance with Financial Accounting Standards Board ("FASB") *Accounting Standard Codification Topic 718, Compensation – Stock Compensation* (formerly FAS 123(R)). Until now, companies have been required to disclose the dollar amount recognized for that year for financial statement reporting purposes.

As clarified by a new instruction to the Summary Compensation Table, the Grants of Plan-Based Awards Table and the Director Compensation Table, for awards subject to performance conditions, the amount to be included in the tables is the value at the grant date based on the *probable (e.g., likely) outcome* with respect to satisfaction of the performance condition, consistent with the recognition criteria in FASB ASC Topic 718 (excluding the effect of estimated forfeitures), *not* the maximum potential value of the award. The *maximum potential value* must be disclosed in a footnote to the Summary Compensation and Director Compensation Tables.

The stock and option awards columns of the Summary Compensation and Director Compensation Tables are only to include amounts for awards with grant dates, as determined for financial accounting purposes, occurring during the year. (This is consistent with the Grants of Plan-Based Awards Table.) While the SEC rejected comments seeking to have the columns instead cover awards granted for services provided in the relevant fiscal year, even if granted after fiscal year-end, the adopting release includes a reminder that companies should (1) continue to analyze in the CD&A their decisions to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of NEO compensation for the fiscal year per Instruction 2 to Item 402(b), and (2) consider including supplemental tabular disclosure where it facilitates understanding of the CD&A.

To facilitate year-to-year comparisons, companies providing Summary Compensation Table disclosure for a fiscal year ending on or after December 20, 2009 are required to present recomputed data for each preceding fiscal year required to be included in the table. The stock and option awards columns amount should be recomputed based on the grant date fair values reported in the applicable year's Grants of Plan-Based Awards Table, except that awards with performance conditions should be recomputed to report grant date fair value based on the probable outcome as of the grant date, consistent with FASB ASC Topic 718. (Remember to recompute the total compensation column too.) If an individual who is an NEO for the most recent fiscal year (2009) also was disclosed as a NEO for 2007, but not for 2008, the individual's compensation for each of those fiscal years must be recomputed. However, companies are *not* required to include different NEOs for any preceding fiscal year based on the recomputed total compensation for those years.

- ***Actions to Take*:** Company counsel should coordinate with and educate the CFO or other appropriate accounting personnel regarding the rule changes. The amendments may affect which executive officers are identified as NEOs for proxy disclosure purposes and may cause the list of NEOs to change more frequently from year to year. Companies should assess as soon as practicable the effect of grant date fair value reporting of equity awards on the determination of their NEOs. The most practical exercise may be to create an illustrative summary compensation table that reflects the new method of valuing equity awards.

C. Noting Pointers for This Year's CD&A and Tables

This is the fourth year under the "new" compensation disclosure rules. Except for the SEC's amendments this year (discussed in **Subpart B** above), there is not much new in terms of mandated disclosure, but a few pointers are worth noting.

(1) Analysis, Performance Targets and Benchmarking

This year companies should focus on making their disclosures more meaningful and understandable. In an important speech given on November 9, 2009, Shelley Parratt, Deputy Director of the SEC Division of Corporation Finance, stated "[w]hen a company explains its compensation decision-making processes but does not explain why it made the compensation decisions it made, [the staff] will ask for enhanced disclosure of the analysis. When a company states that it determined a material element of compensation based on the achievement of performance targets, [the staff] will ask for specific disclosure of the targets and the actual achievement level against the targets, or for the company to provide [the staff] with an explanation of how such disclosure would cause it competitive harm. And if disclosure of material performance targets is not required, [the staff] will insist on meaningful degree of difficulty disclosure. When a company refers to a peer group used for benchmarking purposes, [the staff] will ask for the names of the peer group companies and how you selected them, and where actual awards fell relative to the benchmark."[8]

(2) Pay-for-Performance and Perceived "Windfalls"

A number of companies lowered their expectations at the beginning of 2009 (and performance award thresholds) in light of the cloudy economic situation at that time. Option grants for many occurred at or near low prices during first quarter 2009, when the overall stock market dipped dramatically. With 20-20 hindsight, shareholders might suggest that executives reaped an unearned "windfall" from some of these grants. Companies should be sensitive to, and consider addressing, these concerns in drafting the CD&A. We also recommend that compensation committees evaluate this issue in making upcoming compensation decisions.

(3) Guidance in SEC Staff CDIs, Speeches and Comment Letters

Preparers of proxy statement disclosure should be sure to read over the rules, pertinent SEC speeches (including Deputy Director Parratt's, noted above), staff compliance and disclosure interpretations ("CDIs") and comment letters for peer group companies to ready themselves for this year. Since last year, the SEC staff has added new CDIs regarding compensation disclosure to its website. Moreover, since SEC staff comment letters are publicly available, they provide insight into the staff's specific concerns.

(4) An SEC Staff Warning: You May Need to Amend Your Form 10-K for Compensation-Related Comments

Since the "new" executive compensation disclosure rules were adopted in 2006, SEC staff reviews of compensation disclosure in proxy statements have almost always yielded "futures comments," which ask companies to provide information or required disclosures in their response letters and/or in future filings, as opposed to in an amendment to the filing under review. However, this may change beginning in 2010. According to Deputy Director Parratt, "after three years of futures comments, we expect companies and their advisors to understand our rules and apply them thoroughly. So, any company that waits until it receives staff comments to comply with the disclosure requirements should be prepared to amend its filings if it does not materially comply with the rules."[9]

- ***Actions to Take***: Companies that have not had their compensation disclosures reviewed by the SEC staff in the past several years should not take a "wait and see" approach to improving their disclosures. Amending a Form 10-K (which generally would be necessary to implement "amend" comments received on the annual proxy statement) adds cost and complexity and could interfere with the use of registration statements or other documents incorporating the Form 10-K. All companies should take heed that, beginning in 2010, the SEC has raised the stakes on compensation disclosures. In the words of Deputy Director Parratt, "[n]ow is the time to undertake an earnest attempt to prepare the best possible executive compensation disclosure consistent with the principles set forth in the rules."[10]

D. Complying with Section 162(m) – A Trap for the Unwary in 2010

Under Section 162(m) of the Internal Revenue Code, compensation of certain executives in excess of $1 million that does not qualify as "performance-based" is not deductible by the company for federal income tax purposes. An IRS ruling issued in 2008 states that compensation paid to an executive is not qualified performance-based compensation for purposes of Section 162(m) of the Code, even if the compensation is paid upon the attainment of the performance goal, if any plan, agreement or contract provides that the compensation also would be paid without regard to whether the performance goal is attained in the event of (1) termination without "cause" or for "good reason" or (2) retirement.

Revenue Ruling 2008-13 provided some transition relief which generally will *not* be available in 2010. Under this relief, the ruling position does not apply to arrangements that otherwise qualify for the performance-based compensation exception if either: (1) the performance period for the compensation began on or before *January 1, 2009*, or (2) the compensation is paid pursuant to the terms of an employment contract as already in effect (without giving effect to future renewals or extensions, including any automatic renewals or extensions) on February 21, 2008.

- ***Actions to Take***: Most companies will no longer be able to rely on the IRS's transition relief for their upcoming performance awards. We recommend that companies re-examine the impact of the ruling on their executive compensation arrangements (and determine if any changes are needed) and also ensure that their CD&A disclosure appropriately characterizes the deductibility (or non-deductibility) of such arrangements. Some companies may be able to make awards subject to their unilateral right to make changes (for a brief period of time) in order to cure this issue.

E. Keeping Up With Legislation on the Horizon

There are numerous bills in Congress at various stages of progress that could affect executive compensation and corporate governance in the future (aside from tax legislation and provisions applicable only to financial institutions). None is expected to be effective for the 2010 proxy season, and the likelihood of eventual passage of some is very dubious (*e.g.*, pay caps).

The most recent significant legislative action was passage of the "The Wall Street Reform and Consumer Protection Act of 2009" (H.R. 4173) by the House of Representatives on December 11, 2009 (the "Wall Street Reform Act"). In the compensation area, the Act would require the SEC to issue rules requiring that shareholders have the right to cast a non-binding vote each year approving or disapproving executive pay packages for the company's NEOs (a "say on pay"), as well as a non-binding vote to approve or disapprove "golden parachute compensation" disclosed in proxy materials relating to a change of control transaction. In addition, the Act would require institutional investment managers subject to Section 13(f) of the Securities Exchange Act of 1934 (the "Exchange Act") to report at least annually on how they voted on these matters.

The Wall Street Reform Act would also require the SEC to issue rules directing national securities exchanges to prohibit the listing of any class of equity securities unless the issuer meets heightened independence requirements for each member of the compensation committee, authorizes the compensation committee to retain an independent compensation consultant, independent counsel and other advisors and requires that any compensation consultant or committee advisor meet independence standards to be established by the SEC.

The focus now turns to the Senate, where a more expansive (in terms of executive compensation and governance) bill was introduced on November 10, 2009 by Senator Chris Dodd. It is reported to be undergoing a significant bipartisan overhaul.

- ***Actions to Take***: While it remains unclear whether, or in what form, final legislation will be passed, senior management and directors at public companies should follow these developments closely. Given the level of Congressional interest, and the current political and economic climate, it is likely that we will see elements of these bills become enacted, potentially making the most significant legislative changes in corporate governance since enactment of the Sarbanes-Oxley Act of 2002.

III. Challenges Relating to Proxy Solicitation and Shareholder Communications

We expect the 2010 proxy season to represent a pivotal moment in corporate-shareholder relations. A wave of legislative and regulatory changes that have come, or that are expected to come, into effect will change significantly how companies must approach their 2010 annual shareholder meetings. Equally significant, companies will need to gear up for the potentially greater challenges of 2011. Coupled with more stringent policies recently announced by the leading proxy voting advisor, the changes will increase the influence of institutional investors and the risk of substantial "against" or "withhold" votes in uncontested director elections.

A. Getting the Vote Out: No More Broker Discretionary Voting

Effective January 1, 2010, an uncontested election of directors will no longer be considered a "routine" item under NYSE Rule 452 (which also applies to voting of shares listed on Nasdaq and other national securities exchanges). Thus, without customer instructions, brokers will no longer be permitted to vote shares held for customer accounts.

For many companies, the uninstructed broker vote has often represented nearly 20% of the votes cast, and it generally has favored the board's nominees. With many companies having adopted a majority vote standard for the election of directors, the absence of these shares from the tally of votes cast will increase the significance of the institutional vote and could make the margin of difference in cases where "vote against" campaigns are conducted. In the 2009 proxy season (when brokers were permitted to vote uninstructed shares), at least 91 board nominees, spread among 49 companies, did not receive a majority of the votes cast and, in the case of at least another 223 board nominees, the votes against or withheld amounted to more than 40% of the votes cast.[11] The number of board nominees that did not receive majority support would undoubtedly have been much higher if uninstructed broker votes had not been counted. The risk that a board nominee will fall short of receiving majority support will thus be even greater in 2010.

Usually, where a majority vote standard applies, an incumbent director that has not received the requisite vote is required to submit his or her resignation for consideration by the board. In 2009, in only a handful of the instances where a majority of the votes were cast against or withheld from a board nominee did the company have a director resignation policy – and in those instances the resignations were not accepted by the board. In 2010, more boards may find themselves in the position of having to consider – and publicly justify – whether or not to accept the resignation of a fellow director. In addition, some activist shareholders have begun to focus on resignation policies and are urging companies to adopt policy changes that would make resignation mandatory where majority support was not received.

- ***Actions to Take***: Companies should consider the following in addressing the absence of uninstructed broker votes in 2010:
  - Broker shares held for customer accounts, even though uninstructed, are usually represented at shareholder meetings and are counted for quorum purposes as long as there is at least one routine item to be voted upon at the meeting on which such shares can vote.

Companies that have a large number of retail investors may face problems achieving a quorum at meetings with only the election of directors and other non-routine items on the agenda. Accordingly, companies should consider including on the agenda the ratification of auditors, which is still considered a routine item under Rule 452, to help ensure that a quorum for the meeting can be achieved.

- Companies with a significant retail shareholder base should consider whether it makes sense to adopt or continue to use the "notice-only" option of the SEC's e-proxy rules, at least for this segment of the shareholder population. Companies that have taken advantage of this option, under which companies refer shareholders to proxy materials available online rather than physically deliver paper copies of the materials, have seen a significant drop in voting participation by retail investors. Because of this, companies may wish to use the traditional "full set delivery" option for their retail shareholders, reserving the "notice-only" alternative for institutional investors.
  - Note that the SEC has proposed amendments to the e-proxy rules to respond to concerns about retail shareholder confusion and lower retail shareholder response rates when the notice-only option is used. The amendments would relax the strict limitations on the content of, and the materials that may accompany, the Internet notice, and add flexibility with respect to how the Internet notice is designed.

- Companies should also consider undertaking extra solicitation efforts to encourage retail shareholders to vote, including lengthening the solicitation period.

Of perhaps even greater importance, however, is a robust communications program positioning management and the board to understand and respond thoughtfully to legitimate institutional shareholder concerns, thus heading off single-issue "protest" votes against board nominees. For more on this, see **Subpart G** below.

B. Reporting Voting Results on an Expedited Basis

The SEC's new amendments transfer from Forms 10-Q and 10-K, to a new item on Form 8-K (5.07), the disclosure of the results of a shareholder vote taken at a meeting held on or after February 28, 2010. Now, such disclosure will have to be made within four business days after the end of the meeting at which the vote was held. In response to concerns that voting results may not be available in time to meet the Form 8-K deadline, companies are permitted to file preliminary results within the four business day period and then file an amended Form 8-K within four business days after the final results are known. If the company believes that preliminary results will not be indicative of the final results, the company may include additional disclosure to this effect in the Form 8-K.

- ***Actions to Take***: Companies will need to add a new item to their annual meeting checklists and disclosure controls and procedures. In addition, companies and their investor relations personnel should be prepared to deal proactively with the media and investors following the release of voting results. For example, results announced shortly following a meeting will likely trigger greater media interest, particularly when there has been substantial support in favor of a shareholder proposal or when there have been significant "withheld" or "against" votes cast on a director nominee.

C. Anticipating Proxy Access

While it will not be a factor for the upcoming proxy season, 2010 will be the year when the issue of shareholder access to company proxy material for the election of shareholder nominees will come to a head. SEC Chairman Mary Schapiro has indicated that the SEC will act early in the year on its highly controversial proposal to create a right of access and/or to permit the inclusion in company proxy statements of shareholder proposals seeking to institute access. While the SEC's authority to institute access has been questioned, legislation is pending in the Congress to provide the SEC with express authority to establish access rights and, further, under some proposals to require the SEC to establish access rights.[12]

A major open issue concerning access is the degree, if any, to which the SEC will adopt rules that permit "private ordering," that is, to permit companies to adopt their own access systems where permitted under state law in lieu of, and/or to opt-out of, any otherwise prescriptive access rule the SEC may adopt (assuming legislation on access allows the SEC this flexibility). Amendments to Delaware law that became effective in the summer of 2009 have clarified the validity of access bylaws,[13] eliminating the validity concerns that access requirements previously had raised. An amendment of the Model Business Corporation Act designed to provide such clarification is also pending and is likely to influence the corporation laws of other states.[14] An American Bar Association task force has produced an "Illustrative Access Bylaw" to aid companies in identifying and addressing the complexities faced when fashioning an access regime.[15]

With three of five Commissioners apparently determined to move forward with rule changes to facilitate access following expiration of the extended comment period on January 19, 2010, it seems likely that companies will need to address access (in one of several ways) during the coming year:

- If a right of access is created along the lines proposed by the SEC in 2009, companies will need to take into account the increased potential for contested director elections and, in the course of the year, adjust their nominating procedures to take into account the advance notice schedule of the access rules (assuming the notice provisions are adopted as proposed). Access will further heighten the importance of a robust shareholder communication program.
- The final access rules may permit companies, possibly with shareholder approval, to opt-out or vary the terms of a prescriptive SEC access rule that otherwise would apply. This flexibility may be provided in order to accommodate a company's capital or board structure or other attributes of its voting system. If so, nominating committees will need to decide if they wish to pursue an opt-out or variation and what specific variation of access to pursue.
- Alternatively, if a federal access right is not created, it seems likely that the SEC will change its rules to permit shareholder proposals to institute access under applicable state law; for example, via a bylaw amendment presented for a vote under Rule 14a-8. (Currently, Rule 14a-8(i)(8) permits companies to exclude from their proxy statements shareholder proposals relating to director elections, but the SEC has proposed, along with its federal right of access, to provide that only five categories of such proposals may be excluded.)[16] In this event, companies should expect a wave of such proposals coming to a vote starting with annual meetings held later in the year and during the 2011 proxy season. Boards of directors

accordingly should anticipate that they will need to address the issue of access during 2010; in this scenario, some boards may decide to take a proactive position and themselves institute access.

D. Understanding the Rules for Solicitations by Shareholder Activists

Even without proxy access, shareholder activists may be emboldened in 2010 by the expected impact of NYSE Rule 452, the receptiveness of proxy advisory firms to "short-slate" campaigns (on the theory that they do not result in a change of control) and other aspects of the new environment. Companies should bear in mind the following developments:

(1) Impact of the SEC's New Proxy Disclosure Requirements

An activist will be required to provide the same disclosure regarding the experience, qualifications, other directorships and legal proceedings of its nominees as will now be required by the proxy rules for directors and nominees of the board.

(2) Expense Reimbursement

Amendments to Delaware law that came into effect in the summer of 2009 clarify the validity of bylaws providing for the reimbursement of expenses incurred by a shareholder in running a candidate in opposition to the nominees of the board of directors.[17] HealthSouth, for example, has adopted such a bylaw, under which, subject to certain conditions, a shareholder will be reimbursed for reasonable expenses incurred in soliciting for a single nominee who would qualify as an independent director and was also independent of the nominating shareholder if the shareholder nominee receives at least 40% of the vote cast.[18]

It is likely that reimbursement of solicitation expenses will be discussed at many companies in the coming year, along with the issue of access. This is a subject on which shareholder proposals may be anticipated in 2010, assuming the SEC amends its rules on shareholder proposals relating to director elections as it has proposed to do. The proposed rule seemingly would permit expense reimbursement proposals.

(3) Use of the Board's Proxy Card

The SEC has proposed an amendment to Rule 14a-2(b) that would facilitate communication with shareholders and voting by shareholders on "just say no" campaigns or other efforts to oppose proposals recommended by the board without the need for the activist to prepare and furnish a proxy statement.[19] The proposed amendment would codify an SEC staff interpretation (previously rejected in a 2004 Court of Appeals decision) that extends the availability of an exemption from the proxy statement delivery (and most other) requirements for communications to shareholders made by a person who does not have a substantial interest in a matter and who does not seek authority to vote on the matter (*e.g.*, does not furnish the solicited shareholder with a form of proxy or "form of revocation" of a proxy). Under the proposed amendment, a person opposing a board's solicitation in favor of a matter could deliver to shareholders the board's form of proxy and request that such form be completed with a vote *against* the board's recommendation and sent in to the company without such action being considered an effort to seek a revocation of a proxy and therefore not eligible for the exemption.

The SEC has deferred action on this proposed amendment (as well as that described in (4) below) in light of the interrelationship of these proposals to the pending proxy access proposal.

(4) Rounding Out of Short Slates

Another proposed proxy rule amendment[20] would codify recent SEC staff no-action letters permitting a soliciting shareholder to "round out" its short slate of director nominees (a minority of the board if elected) with nominees named in the proxy statements of other dissident shareholders, in the same manner as already permitted by Rule 14a-4(d) for nominees named in the company's proxy statement.[21] The availability of this rule would be conditioned on the requirement that the dissidents not have agreed to, and must have no intention of, forming a "group" under Section 13(d) of the Exchange Act (often a difficult judgment).

(5) Facilitating the Use of e-Proxy

The SEC has proposed amendments to the e-proxy rules that would facilitate the use by activists of e-proxy solicitation in proxy contests by loosening the timetable for required filings.[22] As proposed to be amended, an activist would be permitted use the "notice-only" option for sending shareholders a proxy statement, by *filing* a preliminary proxy statement within 10 days after the issuer files its definitive proxy statement with the SEC, and *sending* to shareholders notice of the availability of the proxy statement on the Internet no later than the date on which the activist files its definitive proxy statement with the SEC. This would permit the activist more time in which to obtain clearance from the SEC for its definitive proxy statement while still being able to use e-proxy. The amendments would not provide for a specific period of time before the meeting by which the activist would need to mail its Internet notice but the SEC has indicated that there should be "sufficient time" for shareholders to review the proxy statement before voting.

E. Preparing for Shareholder Proposals Aimed at Governance

Early indications are that the 2010 proxy season will witness even more shareholder proposals seeking governance changes than in 2009. There will again be proposals seeking majority voting in the election of directors (especially among companies outside the S&P 500) and proposals seeking declassification of boards – which received, respectively, 56% support on average over 45 proposals and 63% support on average over 67 proposals during the 2009 proxy season.[23] In addition, several other areas are likely to come to the fore in shareholder proposals presented for a vote:

- ***"Say on Pay":*** Unless mooted by legislation (see **Part II.E** above), proposals seeking an advisory vote on executive compensation ("say on pay") are likely to figure prominently among 2010 proposals. They were among the most numerous proposals during the 2009 proxy season (at least 71), receiving on average 46% favorable votes and majority support at 22 companies.[24] The support for these proposals has been building over the past few years and, given the familiarity shareholders have gained with advisory votes on executive compensation resulting from the fact that over 300 TARP recipients were required to have such votes in 2009,[25] majority support seems an increasingly likely outcome this season. Over two dozen non-TARP companies have decided to have "say on pay" votes, including

Microsoft, which will present its executive compensation for an advisory vote every three years.[26] Even without legislation, 2010 may be the year that "say on pay" votes become a major feature of the corporate governance landscape.

- ***Separation of Chairman and CEO:*** Proposals seeking a separation of the positions of chairman of the board and CEO can be expected (assuming such separation is not mandated by legislation); 31 such proposals were brought to a vote in 2009 and received on average 36% support.[27]
- ***Right to Call Special Meetings:*** Proposals seeking to establish the right of a percentage of shareholders (usually 10%) to call a special meeting of shareholders are increasing in popularity; 56 came to a vote in 2009 versus 27 in 2008 and received on average 50.5% favorable votes in 2009.[28]
- ***Barring Executives from Compensation Committees:*** The AFL-CIO pension fund has indicated it will sponsor shareholder proposals seeking to bar corporate executives from sitting on compensation committees, arguing that there is a "built-in" conflict of interest in such situations, as the executives have no interest or incentive to inhibit excessive growth in executive compensation.
- ***Succession Planning:*** The Laborers' International Union of North America has stated that it plans to submit numerous proposals seeking to have boards adopt and disclose detailed succession plans, a proposal it presented at a few companies in 2009.

This year's proposals will reflect two important changes in the SEC Division of Corporation Finance's interpretation of Rule 14a-8(i)(7), which allows a company to exclude shareholder proposals that relate to ordinary, day-to-day business operations.[29] First, unless a proposal "seeks to micro-manage the company," companies generally may no longer exclude a proposal concerning CEO succession planning. Second, consistent with the newly enhanced proxy disclosure requirements relating to board oversight of risk management (see **Part I.D** above), the Division now will consider whether a proposal relating to internal corporate risk assessment or the board's role in the oversight of a company's management of risk raises "policy issues" transcending "ordinary business" matters and, if so, will consider it appropriate for a shareholder vote.

Shareholder proposals that garner significant support carry considerable weight. RiskMetrics Group, the leading proxy advisory firm, has indicated that it will generally recommend a vote against board nominees after a shareholder proposal was adopted by vote of a majority of the outstanding shares or was adopted a second time (by a majority vote, even though not a majority of the outstanding shares) unless the proposal was implemented by the board within the following year. Several of the board nominees who received a high percentage of "against" or "withhold" votes in 2009 received a negative recommendation based on this policy.

F. Considering the Impact of RiskMetrics' Policy Updates for 2010

Looking back at uncontested elections during the first nine months of 2009, RiskMetrics recommended a negative vote with respect to 2,147 directors in the Russell 3000. Notably, the vast majority of directors who received a majority "against" or "withhold" vote received an adverse vote recommendation from RiskMetrics – out of 93 directors at 50 companies who received such a vote, RiskMetrics recommended adversely with respect to 89 of those directors, at 48 companies.[30] According to RiskMetrics, under its voting policies the factors that predominantly led it to recommend negative votes during the 2009 proxy season were the following:

- Tax gross-up payments and other pay concerns,
- Failure to implement a majority-supported shareholder resolution,
- Failure to seek shareholder approval for a poison pill,
- Service of management-affiliated directors on key board committees, and
- Poor attendance at board and committee meetings.[31]

RiskMetrics has updated its voting policies for shareholder meetings to be held on or after February 1, 2010, expanding the circumstances that will lead it to recommend that its clients vote against or withhold votes for directors who are up for re-election.[32] There will now be more than 40 categories of practices that could lead to a negative vote recommendation. The most important changes in RiskMetrics' policies are summarized below:

- ***Evaluation of Compensation Committee Members.*** RiskMetrics will generally recommend a negative vote on the re-election of compensation committee members (or, in rare cases where it deems the full board to be responsible, all directors) if, in its view, (1) there is a misalignment between CEO pay and performance with regard to shareholder value, determined in accordance with certain broad tests, or (2) the company maintains "problematic pay practices" and one of the following three conditions exists: (a) RiskMetrics considers the situation to be "egregious," (b) no management proposal to approve executive compensation is on the ballot or (c) the board has failed to respond to concerns raised in response to prior management proposals to approve executive compensation.
- ***Where Shareholders Are Given a "Say on Pay."*** In determining its recommendation with respect to a management proposal to approve executive compensation (a "say on pay" vote), RiskMetrics will (1) consider whether the company has "problematic pay practices," including policies and practices that could incentivize excessive risk-taking, and (2) assess whether or not the company's policies reflect pay-for-performance, which will now include an assessment of CEO pay relative to a company's total shareholder return over five years.
- ***Adoption or Renewal of Non-Shareholder Approved Poison Pills.*** RiskMetrics will now recommend a negative vote with respect to all continuing directors where a board has, without shareholder approval, (1) adopted a "poison pill" with a term of more than 12 months, (2) renewed any pill or (3) made any "material, adverse change" to an existing pill. Where a board has adopted a pill with a term of 12 months or less without shareholder approval, RiskMetrics will now make a recommendation on a "case-by-case" basis on the board's nominees. In addition, RiskMetrics will increase its scrutiny of companies that have maintained an existing pill that has not been previously approved by shareholders. It will consider maintenance of a pill without shareholder approval, in the context of the company's overall governance practices, every year if the company has a classified board or at least once every three years if the company does not have a classified board. Starting as soon as 2011,

upon making this review, RiskMetrics may look to maintenance of a pill without shareholder approval as a basis for voting against the board's nominees.

- ***"Egregious Actions."*** RiskMetrics will define more broadly the "egregious actions" for which it will recommend negative votes for individual directors, for a specific committee or for the entire board. In addition to its existing criteria, which relate to failure to replace management as appropriate, RiskMetrics will consider (1) "material failures of governance, stewardship or fiduciary responsibilities at the company" and (2) actions related to a director's service on *other* boards that "raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders" at *any* company.

RiskMetrics typically provides companies that are in the S&P 500 with prior warning if it intends to issue a recommendation to vote "against" or "withhold" from a director and companies are given a very narrow time window (48 hours) in which they can respond and engage with RiskMetrics on the issue. Companies that are not in the S&P 500 generally do not receive such prior warning.

- ***Actions to Take:*** We encourage all companies to become familiar with the circumstances in which RiskMetrics may recommend a vote "against" or "withheld" from your directors so that companies are better prepared to engage with RiskMetrics within a tight timeframe. Companies may also wish to proactively contact their analyst at RiskMetrics in anticipation of or shortly after proxy statement filing to talk through any issues that could cause RiskMetrics to recommend a vote "against" or "withhold" from a director.[33]

G. Communicating With Your Shareholders

In light of these pressures, we recommend that companies review their shareholder communications programs to assess how well they elicit information about what their shareholders care about and, thus, enable management and the board to respond to legitimate shareholder concerns. Companies will be well-served by moving beyond traditional "buy-side" investor relations to experiment with more creative ways to obtain shareholder viewpoints on key issues. These can range from broad surveys to targeted meetings with large long-term shareholders to discuss particular issues such as compensation or board composition. SEC Regulation FD does *not* prevent a company's board or other representatives from *listening* to shareholders, and therefore should *not* be erected as a shield against constructive dialogue.

In addition to providing management and the board with important information about shareholder viewpoints, these efforts may provide a foundation for supportive shareholder relations in the future. Some examples:

- ***UnitedHealth Group*** formed a Nominating Advisory Committee in 2006 to provide advice to its Nominating Committee on the appropriate characteristics and composition of its board. The committee consists of representatives of significant shareholders and at least one member of the medical community.
- ***Schering-Plough*** established a Shareholder Engagement Program in 2003 including presentations to shareholders by senior management and other key employees, dialogue

between shareholders and senior management and the investor relations professionals and surveys of shareholders with respect to majority voting and compensation.

- ***Microsoft*** launched a blog in 2009 devoted to "news, perspectives and analysis on legal and policy issues," inviting shareholders to use the blog to communicate with the company about corporate governance matters. Company officers have recently used the blog to express the view that companies must have flexibility to customize corporate governance arrangements in ways appropriate for them, and to communicate decisions of the Microsoft board in keeping with this philosophy (*i.e.*, to recommend amendments to the company's articles that would give shareholders representing at least 25% of the outstanding shares the right to call a special meeting, and to adopt a triennial "say on pay").
- ***Goldman Sachs*** began meeting with shareholders to discuss its earnings and compensation principles after its earnings announcement in October 2009. The company posted a copy of its presentation materials on its website, to explain, among other things, its view of how the company's compensation practices create long-term value for shareholders. At these meetings, the company reportedly asked investors what influences their decisions when they vote on shareholder proposals. In December 2009, the company issued a press release announcing the following changes to its compensation structure: (1) its management committee will receive all discretionary compensation in the form of "shares at risk," which will be subject to a five-year vesting restriction, (2) recapture and clawback provisions will be enhanced, and (3) it will seek an advisory vote on executive compensation at its 2010 annual meeting of shareholders. In the press release, Goldman Sachs noted that by subjecting its compensation principles and executive compensation to a shareholder advisory vote, it was further strengthening its dialogue with shareholders on issues of compensation.[34]

H. Keeping Up With Regulatory Initiatives

In 2010, in addition to action on the SEC proposals described above, companies should anticipate further rulemaking initiatives regarding proxy solicitation and beneficial ownership reporting. Some of these will be undertaken jointly at the SEC staff level by the Division of Corporation Finance and the newly formed Division of Risk, Strategy and Financial Innovation led by Henry Hu, a former law professor and well-known expert on derivatives.

(1) Improvements to the Current Proxy Voting System (a/k/a "Proxy Plumbing")

The SEC is expected to issue a concept release addressing proxy voting mechanics and related issues, including:

- Accuracy in vote tabulation, given the shift to majority voting and the demise of broker discretionary voting in uncontested elections (among other developments leading to closer vote results),
- Whether votes are being cast by persons without an economic interest in the underlying securities (e.g., "overvoting" and "empty voting" concerns),
- How to solve the problem of recent declines in retail voting rates, particularly after e-proxy,

- Whether or not to facilitate public companies' ability to communicate directly with street-name holders of their stock (e.g., whether to modify the current NOBO/OBO system created by the proxy rules),
- The role of proxy advisory firms such as RiskMetrics, Glass Lewis and The Corporate Library in influencing shareholder voting decisions, including an examination of reported conflicts of interest relating to individual firms,
- Whether or not shareholders should be allowed more easily to communicate with each other free of regulatory constraints, and
- Whether or not the current rules otherwise need to be amended to keep pace with state-law developments, such as Delaware's adoption of dual record dates for annual meetings.

(2) Beneficial Ownership Reporting

The two SEC Divisions are collaborating on rule proposals that, among other things, potentially could expand the current definition of "beneficial ownership" for purposes of Regulation 13D/G to cover various equity derivatives that now fall outside the ambit of the reporting scheme.

In addition, pending legislation could expand the SEC's authority (*e.g.*, the Wall Street Act passed by the House would give the SEC authority by rule to shorten the "ten-day window" for initial filing once the 5% beneficial ownership threshold is crossed).

IV. Financial Reporting Challenges

In preparing this year's Form 10-K and annual report to shareholders, a central concern, once again, is risk. Companies should keep in mind the heightened importance of providing "early warning" to investors in the event the company faces specific, material risks that, if triggered, could have a material adverse effect on its liquidity, capital resources or results of operations. If your company's Form 10-K is selected next year for review (along with its other Exchange Act reports and 2010 proxy statement, in most instances), you should anticipate that the SEC staff will be asking these key questions with respect to a range of disclosure items: *"What did the company's management know, when did it know it, and should the company have provided an earlier warning to investors?"* [35]

We expand upon the existing risk-centric disclosure requirements below. Down the road, the SEC staff is thinking about ways to focus and unify now-discrete and dispersed disclosures on what specific risks the company is facing, how the company is addressing those risks (including mitigation measures) and how the board oversees management of those risks and, more generally, to provide a unified discussion of enterprise-wide risks.

A. Risk Factor Disclosure

Arguably, the lowest threshold for risk disclosure is contained in Item 1A of Form 10-K, which requires disclosure of the company's "material" risk factors.[36] The key to disclosure is "materiality" as defined for antifraud purposes, which means whatever a reasonable investor in the company's securities would consider important in deciding whether to buy, sell or hold those securities. We strongly recommend that special care be taken this year in drafting risk factors and highlighting them to your company's board of directors (or responsible committee) as part of the risk management oversight activities it will be discussing in the upcoming proxy statement (see **Part I.D** above). Recall that only "meaningful cautionary statements" in a company's Exchange Act reports will afford protection under the Private Securities Litigation Reform Act of 1995 (the "PSLRA") and SEC safe harbors available for the mandatory forward-looking disclosures made in the MD&A as well as for any voluntary forward-looking disclosures provided in a particular Exchange Act report (other than, in the case of the PSLRA safe harbor, the financial statements).

A few additional tips from senior SEC staff members, as delivered late this year in remarks at various conferences:

- Industry-wide, and even global, risks are disclosable to the extent that they may, if realized, have a material adverse impact on your company. Explain these risks with specificity; don't use boilerplate or include mitigating language in the risk-factor section. If you want to explain how your company manages and mitigates a particular risk, use the MD&A. As discussed in **Part II.B** above, material risks tied to incentive compensation – for both executive and non-executive employees – will have to be addressed in the 2010 proxy statement.
- Given the unprecedented volatility of the U.S. and global securities markets and economies during the past year, companies should evaluate the need for new or updated risk disclosures,

which may be company-specific or linked more broadly to industry, market or macro-economic trends. Examples provided by the staff include the following:

- Liquidity problems resulting from difficulties raising capital, selling financial assets that are no longer deemed liquid because the relevant market remains frozen or has disappeared (*e.g.*, auction-rate securities acquired by many corporate treasuries), or refinancing outstanding debt, much of which either has or soon will be coming due; changes in debt covenant ratios or declines in credit ratings that may trigger default and cross-default provisions in other outstanding debt, and even leases; finally, in a worst-case scenario, going-concern warnings.
- Risks of material impairment of non-financial assets like goodwill, deferred tax valuation allowances and patents.
- Significant declines in the fair value of pension plan assets, potentially leading to a material increase in the company's funding obligations that must be recorded in the financial statements.
- Increased risk of hedging ineffectiveness, as well as counterparty default risk, in connection with derivative products used to mitigate a variety of market or credit risks (*e.g.*, interest rate and currency volatility).
- Enhanced risk of loss of major customers and/or suppliers that are experiencing sharp business declines or even bankruptcy.
- Enhanced regulatory and/or litigation risks due to changing environmental laws and regulations.

Note that corporate disclosure of environmental risks has become a particular focus of SEC Commissioner Elisse Walter and the SEC's recently formed Investor Advisory Committee, signaling the strong potential for SEC rulemaking in this area.[37]

B. Form 8-K Risk-Related Items

There are several Form 8-K disclosure requirements that, if triggered, compel anticipatory disclosure of certain material risks facing the company:

- Item 2.04 – if a reportable direct financial obligation arises from an off-balance sheet arrangement, the company must disclose, among other information, potential cross-default implications arising from the off-balance sheet arrangement.
- Item 2.05 – a decision about material prospective restructuring costs.
- Item 2.06 – a decision about material impairment. Intra-period testing may be necessary under certain circumstances, such as if there has been a significant decline in the company's market capitalization below book value on a reporting unit basis or the company has sustained recurring operating losses and/or fails to meet analyst earnings expectations. The SEC staff has been asking, after the fact, why some companies are not conducting impairment testing earlier than the normal, U.S. GAAP-prescribed year-end date.
- Item 4.02 – a decision that a material error exists in the financial statements, which is seen as a proxy for imminent restatement in most instances.

C. Risk-Related Elements of MD&A

For several years, the SEC staff has been emphasizing the vital importance of providing "known trends and uncertainties" disclosure in the MD&A sections of Forms 10-K and 10-Q. Now, more than ever, the SEC expects companies to use the MD&A to explain the effects of the financial and economic crises on the quality and variability of earnings and cash flows.

Companies must tell investors in the MD&A not only what happened during the year that had a material impact on their results of operations, liquidity and capital resources, but also what management believes is reasonably likely to happen in future reporting periods that will have – or is reasonably likely to have – a material impact on each of these performance elements down the road. In short, the SEC expects "to see companies recognize trends and uncertainties sooner; make reasonable likelihood determinations before they become more likely than not; and disclose this information to investors so that they can make their own, fully-informed investment decisions. And these disclosures should be made in a way that communicates to shareholders."[38]

(1) SEC Early-Warning Hot Buttons

The SEC staff has been expressing serious concern regarding companies' failure to provide a timely "heads-up" in the MD&A of material contingencies before they become probable for financial-statement accrual purposes, or otherwise ripen into actual losses and/or liabilities. Along with the SEC staff in the review-and-comment process, your auditors will be scrutinizing the 2010 MD&A and accompanying financial statements carefully for signs of the following harbingers of financial distress: [39]

- Potential material impairments of acquisition-related goodwill, financial assets (*e.g.*, securities, loans) and long-lived intangible (and tangible) assets. With respect to goodwill in particular, companies should be aware of the staff's continuing concern that improper aggregation of operating segments for testing purposes has facilitated concealment of incipient impairment risks.[40]
- Material litigation loss contingencies, including those attributable to climate change and other potential or actual sources of environmental liability exposure.[41]
- Projected material increases in pension and other postretirement benefit obligations.
- Estimated future restructuring costs, where material.
- Indicators of a material liquidity "crunch," or even a going-concern problem – as noted above in connection with risk factors, these may entail material declines in cash flows from operations, financing or investment, maturing debt, credit rating downgrades and other possible events of default and cross-default on multiple debt obligations.
- Material changes in valuation allowances for deferred tax assets, and uncertain income tax positions.
- Possible implications, if material, of the company's adoption, beginning January 1, 2010, of a new U.S. GAAP pronouncement that will require consolidation of material off-balance sheet arrangements not only by many financial services companies, but also by companies in other sectors that soon could be deemed to be the "primary beneficiaries" of previously

unconsolidated joint ventures, operating partnerships and other, previously unconsolidated enterprises (see Staff Accounting Bulletin No. 74).[42]

This list of SEC staff "hot buttons" is only illustrative. For example, a company may be at risk for significant losses in the credit derivatives market because its hedging transactions ultimately may prove to be ineffective – if so, the SEC staff will expect an MD&A (and risk factor) warning of this contingency, if material, under the mandatory "known trends and uncertainties" analysis. Or a financial services company engaged in consumer lending activities may have observed material increases in the rates of default or in the severity of declines in collateral value that either have forced, or could force, a change in loan-loss allowance practices or provisioning – another area on the SEC accounting staff's radar screen.[43] At the end of the day, there is a single unifying principle that ultimately will guide the SEC staff in conducting what is tantamount to a forensic inquiry, during the review-and-comment process, into the reasonableness of management's disclosure decisions as revealed in the 2010 MD&A and in determining whether to require amendments to previously filed periodic reports: *Did management know (or should management reasonably have known, based on all relevant facts and circumstances) about a given trend, demand, commitment, event or uncertainty? And, if so, could management say that (1) it was not reasonably likely that any such trend, demand, commitment, event or uncertainty would occur or (2) if management could not make that determination, that the trend, demand, commitment, event or uncertainty – should it occur – was not reasonably likely to have a material adverse effect on the company's financial condition or results of operations?*[44]

(2) Sensitivity Analyses

To an increasing extent, the SEC and its staff are urging – and even requiring, where a particular accounting standard constitutes a critical accounting estimate for the company – the inclusion in the MD&A of sensitivity analyses that show the potential material effects on a company's financial condition and results of operations, under varying scenarios, if a particular material risk or combination of risks actually were to materialize. As the SEC put it in its most recent MD&A interpretive release: "Since critical accounting estimates and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should provide quantitative as well as qualitative information where quantitative information is reasonably available and would provide meaningful information to investors."[45]

Areas in which the SEC or its staff members have called for some form of sensitivity analysis, to the extent quantitative information is reasonably available and the item is material to the company's investors, include pension plan funding obligations,[46] the fair value of financial assets and liabilities,[47] and off-balance sheet arrangements susceptible to consolidation (*e.g.*, joint ventures, financing vehicles).[48]

D. Other Challenges Related to Financial Reporting

(1) Website Postings and Other Disclosure Outside of SEC Filings

Financial reporting concerns do not just begin and end with disclosure in SEC filings. Senior SEC staff have emphasized this year the need to consider whether the information conveyed in your company's website postings, and other disclosures made outside of an SEC filing, are consistent with its SEC filings. In reviewing the 2010 Form 10-K, the staff has promised that it will examine your company's web-posted earnings calls (replay or real-time), those analyst conferences that are open to the public and/or picked up by the trade media, company press releases, and even articles relating to the company in such publications as *The Wall Street Journal*, to see whether the company's presentations of its business and/or financial condition, past or prospective, as reflected in these venues are consistent with and/or included in the required disclosure documents. Recently, a senior staff member warned that the reviewing staff may take into account analyst research reports.

In particular, the staff will compare U.S. GAAP-compliant segment definitions disclosed in SEC filings with how the company presents its lines of business in communications with analysts and investors, and will scrutinize the company's use of non-GAAP financial measures within and outside of company filings. The staff is revisiting its existing interpretations of SEC Regulation G with a view toward determining whether they are appropriate in light of assertions that these interpretations are too rigid and discourage companies from disclosing, in SEC documents, those non-GAAP financial measures that are communicated informally to analysts and investors through other media. In the meantime, however, the staff has warned that the company likely will receive a comment asking why such non-GAAP information is not disclosed in SEC filings. And the SEC recently brought its first case charging a company with violations of Regulation G in the context of a broader earnings management scheme, as discussed further in **Part V.B.5** below.

(2) Earnings Guidance

Many companies are continuing to re-evaluate whether they can or should continue to forecast EPS or provide other forms of earnings guidance and, if not, whether they can or should provide a "business outlook" in their earnings releases and/or earnings calls and, if so, whether the outlook should at least be a long-term one (*e.g.*, full year vs. next quarter). If an outlook is adjusted downward from a previously published outlook, consider providing more context around the revised outlook, including the underlying assumptions and a general description of steps the company may take to counteract the adverse business environment. Above all, do not forget the need for "meaningful cautionary statements" and, if non-GAAP performance measures are used, the need to comply with SEC requirements for reconciliation to U.S. GAAP.

(3) Disclosure-Related Controls and Procedures

Last year, we cautioned that, in light of the potential for market events to trigger disclosure duties, it was advisable to review afresh the company's disclosure-related controls and procedures to ensure that information was flowing smoothly and efficiently within the organization so that the SEC mandate of timely disclosure could be met. Although there have been some market improvements in the past year, companies should not relax their vigilance in this regard. In particular, consider whether existing policies and/or procedures may need to be revised in light of the company's financial condition (including its credit risk or that of counterparties) and market conditions, as well as recent and soon-to-be proposed modifications to U.S. GAAP by the FASB in response to issues illuminated by the global financial crisis (*e.g.*, fair value and off-balance sheet accounting and accounting for financial instruments generally).

These revisions may constitute a material change to the company's internal control over financial reporting ("ICFR"), or a change reasonably likely to materially affect ICFR in the future, and therefore require disclosure in the upcoming periodic report under Item 308(c) of Regulation S-K. In this connection, note that the SEC staff has been asking companies that disclose ICFR deficiencies in the year-end management report (and/or the outside auditor's opinion) in their Form 10-K why no changes in such ICFR were foreshadowed in previous quarterly reports on Form 10-Q. Where no deficiencies or ICFR changes are disclosed, but the company has undergone extensive restructuring, the staff may challenge the absence of "material change" disclosure.

In September 2009, the Public Company Accounting Oversight Board ("PCAOB") published a report on the quality of ICFR audits in connection with the first year of implementation of Auditing Standard No. 5 ("AS 5") governing such audits.[49] The report, which summarized the results of PCAOB inspections of 250 "integrated" audits covering both ICFR and the financial statements, concluded that the "Big Four" and four other, smaller firms by and large had done a fairly good job of making the transition to AS 5 from its much-maligned predecessor, Auditing Standard No. 2. Because the report identified certain areas of ICFR audit deficiencies, however, companies should expect their outside auditors to display considerably more "professional skepticism" during the upcoming integrated audit of their 2009 annual financial statements and ICFR with respect to the following areas:

- Inadequate risk assessment in determining significant accounts and disclosures, selecting which controls to test, and assessing the level of audit evidence necessary for a given control.
- Inadequate attention to the risk of management fraud; *e.g.*, in regard to testing the operation and design of controls targeting the risk of management override.
- Excessive reliance on the work of others to reduce the auditor's own work.
- Inadequate testing of entity-level controls; *e.g.*, not looking beyond the control environment and period-end reporting processes.
- Deficiencies in the nature, timing and effectiveness of control testing; *e.g.*, the auditor's testing of controls over financially significant applications was dependent on the appropriate segregation of duties, but no testing was performed to determine whether the segregation of duties was appropriate in the first place.
- Deficiencies in evaluating and communicating control deficiencies to management and audit committees.

In light of impairment concerns and other issues raised by the ongoing market and economic crises, along with the above-noted critiques from the PCAOB, expect your auditors to pay close attention to written policies and procedures for determining fair-value measurements and related disclosures, as well as the adequacy of supporting documentation reflecting their appropriate application. Expect strong auditor skepticism regarding management reliance on third-party valuation estimates when it comes to fair value judgments and assumptions, especially for pension funding obligations. Also, consider the extent to which any policies and/or procedures are applied consistently, and whether they are susceptible to improper management override (which in turn exacerbates the risk of material misstatement in the financial statements).

Management should also take into consideration any potential impact on the company's disclosure controls and procedures during its quarterly evaluation (for calendar-year registrants, it will be the fourth quarter that will be discussed in the upcoming Form 10-K) and adjust those processes as needed.

(4) Regulation FD

Continue to resist the temptation to discuss the company's performance privately with analysts or large shareholders during these turbulent times absent advance or simultaneous public disclosure of material, performance-related information to the broader market. Expect large institutional investors and/or analysts to apply pressure for more "outlook" information between periodic filings. For a discussion of a recent SEC enforcement case illustrating the dangers to individual officers and directors of failing to adhere to an otherwise effective corporate Regulation FD policy barring selective disclosure, see **Part V.B.4** below. Note that individual violations of an FD policy can result in SEC charges of illegal tipping in violation of the federal antifraud rules, which also can trigger Department of Justice ("DOJ") criminal charges against the individual. By the same token, as discussed in **Part III.G** above, do not use Regulation FD as a barrier to legitimate communication with your shareholders.

(5) Insider Trading Compliance and Use of Rule 10b5-1 Plans

Because there is continued focus on insider trading and tipping by a reinvigorated and highly motivated SEC Division of Enforcement, working in conjunction with the DOJ in many situations, vigilance should be maintained in this important area of compliance risk. The SEC is willing to sue outside directors (as well as senior executives and lower-level employees) if the agency believes that there has been a breach of the duty of trust and confidence owed to the company, regardless of whether the individual director, executive or employee profited in a case involving illegal tipping. As if to underscore this point, the Director of this Division recently reminded audit committees of their oversight responsibilities in the area of fraudulent financial reporting, which is often accompanied by unlawful insider trading.[50]

A particular area of concern in the SEC's ongoing war against insider trading is the use by corporate insiders of "10b5-1 trading plans." Since 2000, these plans have enabled officers, directors and others, including the company itself, to assert an affirmative defense in litigation charging illegal trading in company stock "on the basis of" material, non-public information, so long as certain specified conditions are met. One of the most important of these conditions is that the trading plan was created at a time when the creator was not aware of material, non-public information. Companies should require pre-clearance of both the establishment and any proposed modification of insiders' Rule 10b5-1 plans, just as they would for any purchase or sale of company stock (and, in many cases, other securities of the company) by insiders. In what amounts to a clear shot across the bow, the SEC recently charged a former CEO with fraudulent insider trading despite his reliance on several 10b5-1 trading plans. See **Part V.B.7** below for further discussion of this case.

(6) Company Stock and Debt Buy-Backs

In executing repurchase programs, whether for equity or debt securities, companies should continue to consider the following regulatory parameters:

- Consider Rule 10b-5 antifraud concerns. Repurchases should not be made when the company is aware of material, non-public information unless it has a 10b5-1 plan in place, and the plan was entered into when the company was not aware of material, non-public information. As with officer and director 10b5-1 plans, company plans covering open-market purchases should not be modified or terminated in a manner that calls into question the good-faith nature of the plan. Regardless of whether the company has chosen to rely on Rule 10b5-1 – which to date has been invoked primarily for equity securities – it will need to weigh its antifraud disclosure obligations to those securityholders from whom it purchases, as well as to the markets generally if the buyback program itself may constitute material information. Regulation FD concerns also come into play if the company attempts to deal with its antifraud disclosure duties by making selective disclosure of material, non-public information to selling securityholders without also making the necessary widespread public disclosure of such information to all investors.
- In planning a repurchase of equity securities, consider the applicability of Rule 10b-18 (offering a limited safe harbor from certain anti-manipulation provisions for issuer repurchase plans under specified conditions) and Regulation M (prohibiting purchases by an issuer or its affiliates during a "distribution," which could include private placements depending on the applicable facts and circumstances).
- Finally, depending on the magnitude, timing and other terms of a repurchase, the company may need to comply with the SEC's Exchange Act tender offer requirements. Company repurchases of equity securities, if deemed to constitute a tender offer, are subject to extensive filing and disclosure obligations centered in Rule l3e-4, as well as the tender offer (Section 14(e) and Regulation 14E) and general antifraud (Section 10(b) and Rule 10b-5) provisions. Consideration of the going-private provisions of Section 13(e) and Rule 13e-3 also may be necessary. With respect to debt buybacks that take the form of tender offers, Section 14(e) and Regulation 14E (and Rule 10b-5) would apply in the case of non-convertible debt, and Rule 13e-4 (and potentially the going-private provisions of Rule 13e-3) in the case of debt securities that are convertible into equity.

V. Challenges of a More Aggressive Enforcement Environment

Confronted with an avalanche of criticism from Congress, the SEC's own Inspector General and an angry investing public in the wake of the $50-plus billion Madoff Ponzi scandal, the SEC and its Enforcement Division have launched an aggressive initiative to overhaul and streamline the agency's enforcement program. Led by former federal prosecutor Robert Khuzami, the Enforcement Division has flattened management ranks to devote more resources to investigations, created specialized, nationwide units to focus on combating sophisticated fraudulent schemes and other abuses, forged closer ties with federal criminal authorities, and otherwise taken sweeping steps to enhance the Division's effectiveness. A recent rebuke from a federal judge, in rejecting as inadequate the SEC's proposed $33 million settlement with the Bank of America, seemingly has served only to reinforce the Division's new, "get-much-tougher" approach.[51]

Companies are well-advised to reassess the effectiveness of their compliance policies and procedures in light of the SEC's renewed determination both to keep pace with the increasingly complex securities markets, the disruption or collapse of which contributed to the recent financial and economic crises, and to prevent any recurrence. To help companies adapt to the heightened enforcement risks they are now facing, we describe below what we see as the more significant aspects of the Enforcement Division's restructuring and policy initiatives, and discuss specific enforcement priorities – such as insider trading and tipping, Regulation FD and the Foreign Corrupt Practices Act ("FCPA") – that have particular relevance to public companies. Wherever possible, we cite individual "message" cases that underscore these priorities and offer guidance on building and maintaining effective corporate compliance programs. We close with a brief outline of pending Congressional measures that, if adopted in 2010, would strengthen and expand the SEC's enforcement powers.

A. Structural and Policy Changes in the Enforcement Division

(1) Hiring former prosecutors as Director, Deputy and head of the New York Regional Office

Both Mr. Khuzami and his Deputy, Lorin Reisner, are experienced former prosecutors who worked together for many years in the U.S. Attorney's Office for the Southern District of New York, along with George Canellos, the new head of the New York Regional Office.

(2) Eliminating a layer of management, and "redeploying" former managers to the field

Former Branch Chiefs have been reassigned to investigative work, as part of a broader effort to "push more decision-making to the front-line staff."[52]

(3) Creating new, specialized units

Five new units have been established to cover the following areas under the Division's spotlight: (1) the FCPA, (2) market abuse and hedge fund insider trading (which is taking aim at corporate tippers, as the SEC's enforcement action against the hedge fund Galleon Group illustrates), (3) derivatives and other specialized financial products, (4) market manipulation and fraud among investment advisers and other market professionals, and (5) municipal securities and pension plans.

(4) Streamlining the formal order process to reduce delays in issuing subpoenas

Subject to certain exceptions, the SEC has delegated to the Enforcement Division Director the authority to issue formal orders of investigation, with their accompanying subpoena power. Director Khuzami has announced that he in turn intends to delegate that authority to senior officers throughout the Division so that they will no longer have to obtain advance approval in most cases to issue subpoenas. As he put it recently: "This means that if defense counsel resist the voluntary production of documents or witnesses, or fail to be complete and timely in responses or engage in dilatory tactics, there very likely will be a subpoena on your desk the next morning."[53] The Director also announced that the Division is streamlining decision-making by delegating the power to approve all routine case decisions from the Deputy Director at a national level to Division senior officers located throughout the country.

(5) Changing the SEC's penalty approach

Chairman Schapiro has eliminated the "pilot" penalty program established by former Chairman Cox, which required the staff to seek SEC approval before negotiating penalties and other sanctions with prospective defendants or respondents. Because the Division's staff once again has the authority to negotiate penalties and other sanctions in connection with potential settlements, we should no longer see the protracted delays observed in recent years as individual Commissioners debated proposed penalties before settlement agreements were reached. There also will be greater focus in the settlement context on individual accountability and cooperation. Director Khuzami has indicated that his Division is working on standards for rewarding individual cooperation, in essence creating a set of *Seaboard* standards for individuals subject to SEC enforcement scrutiny.[54]

(6) Seeking "clawbacks" from non-charged executives

For the first time, the SEC has invoked the Sarbanes-Oxley Act "clawback" provision, Section 304, to seek recovery of incentive compensation in a fraudulent financial reporting case from an individual executive *who has not been charged with wrongdoing*. Earlier this year, the SEC sued the former CEO of CSK Auto Corp., seeking recovery of bonuses he had received during the three years in which the company was allegedly committing accounting fraud. There was no allegation that the former CEO played any role in the alleged misconduct.[55]

(7) SEC participation in new Financial Fraud Enforcement Task Force

The Obama Administration recently announced the formation of a new government-wide Financial Fraud Enforcement Task Force, in which the SEC will participate. Director Khuzami said that "[t]he Task Force should only increase those numbers [in fiscal 2009, more than 150 cases brought by SEC were filed in coordination with DOJ and other criminal law-enforcement authorities, an increase of 30% over the SEC's fiscal 2008] and provide even greater opportunity for close collaboration and information sharing among law enforcement authorities."[56]

(8) Enhancing cooperation with foreign law-enforcement authorities

The Division has redoubled its efforts to increase cooperation with foreign governmental authorities in pursuing transnational securities law violations. Particular areas in which enhanced coordination efforts have been apparent include anti-bribery and insider trading, among others.

(9) Centralized tip collection and analysis

A new Office of Market Intelligence has been established to collect and evaluate the hundreds of tips received by the agency, in an effort to detect and prevent the next Madoff-like debacle.

B. Current SEC Enforcement Priorities

As illustrated by recent civil fraud cases and administrative proceedings – both pending and settled – as well as investigations disclosed by companies (which the SEC will not comment upon), the following are priority areas of the Enforcement Division, in addition to the more traditional "bread-and-butter" financial reporting cases:

(1) Fall-out from the financial crisis

This is a work-in-progress for the Enforcement Division. On the leading edge are the auction-rate securities cases the SEC has brought against the investment banks, most of which have ended in settlements/restitution to individuals, non-profit charities and endowments, and public pension funds. (Note that companies have been bringing cases against the banks because they haven't been covered by these global settlements.). In addition, there have been cases against former executives of subprime lenders New Century Financial Corporation, American Home Mortgage Corp and Countrywide Financial for failure to disclose mortgage-lending risk exposures, as well as a case against the former CAO of Beazer Homes for orchestrating "an old-fashioned 'cookie jar' [reserves] earnings management scheme" designed to prop up the company's financial results as the housing market declined.[57] A California broker-dealer and its CEO were just sued by the SEC for selling risky mortgage-backed securities to retail customers with conservative investment goals.[58]

(2) Market abuse by hedge funds and other market professionals

From the Enforcement Division's perspective, market abuse means using any or all of the equity, fixed income and derivatives markets to engage in fraud, manipulation and other forms of misconduct. The SEC has been particularly concerned that the lack of transparency in the derivatives markets adds a new and more dangerous dimension to market-related misconduct, such as insider trading. Acting on such concerns earlier this year, the SEC instituted its first case involving credit default swaps, charging a former hedge fund portfolio manager and a salesman at Deutsche Bank with insider trading in the credit default swaps ("CDS") markets in anticipation of a debt restructuring by the bank's corporate client (the banker allegedly tipped the hedge fund manager about the impending debt deal, who in turn traded in the CDS before the deal was announced publicly).[59]

(3) Ponzi Schemes

Although Ponzi schemes have always been a priority of the Division, the Director recently announced that, in light of the massive Madoff fraud and the financial crisis, Ponzi schemes have become an even higher priority. Between January and early December of this year, the Division filed more than 55 cases involving Ponzi or Ponzi-like payments.

(4) Regulation FD

A recent case indicates that this rule barring selective disclosure of material, non-public information is alive and well (along with insider trading in the form of tipping, as discussed further below). The recent, settled SEC case against Christopher Black, the former CFO of American Commercial Lines, highlights the clear benefits of greater corporate attention to tightening Regulation FD and insider trading (anti-tipping) policies and training personnel. As the designated IR official, the former CFO sent an e-mail to eight sell-side analysts that "effectively cut in half [the company's] previous second quarter earnings guidance," which allegedly led to a significant drop in the market price of the company's stock. Mr. Black consented, without admitting or denying culpability, to the entry of a permanent injunction ordering him to pay a $25,000 penalty. However, the SEC decided not to sue the company because it "had cultivated an environment of compliance by providing training regarding the requirements of Regulation FD and by adopting policies that implemented controls to prevent violations. [Mr. Black] alone was responsible for the violation, and he acted outside the control systems established by ACL to prevent improper disclosures." Among several other mitigating factors were the company's prompt disclosure of the lower earnings guidance in a Form 8-K, and its decision to self-report the FD violation to the SEC staff the day after it was discovered. [60]

(5) Regulation G

The SEC's civil injunctive action against Safenet, Inc. and the former CEO and CFO, respectively, involved fairly typical fraudulent earnings management and options backdating schemes. This case is notable, however, because it represents the first time that the SEC has brought an enforcement action under Regulation G governing the disclosure of material information containing a non-GAAP financial measure.[61] With respect to Regulation G, the SEC charged that the company and two former executives represented to investors that the company's non-GAAP earnings results excluded certain non-recurring expenses which in fact were recurring, in order to meet or exceed quarterly EPS targets.

(6) FCPA

The SEC has redoubled its efforts in connection with enforcing the anti-bribery, books-and-records and internal accounting control provisions under the FCPA amendments to the Exchange Act, working in close partnership with the DOJ, which often brings parallel criminal cases. As noted, a new unit in the Enforcement Division is now focusing exclusively on these violations, and is suing individuals as well as companies. Because of the heightened pressures on employees to generate profits in tough economic times, and the expansion of many businesses into developing countries where bribery may be customary, if not sanctioned by law, companies should rigorously review their existing anti-corruption and antifraud programs to ensure that they are clearly stated in writing, address country-specific risks, and are reinforced through periodic training and consistent enforcement.

Among the more significant cases brought this year:

- In July 2009, the SEC filed and settled an FCPA (anti-bribery and books-and-records/internal accounting control provisions) civil enforcement action against Nature's Sunshine Products, Inc., along with its CEO and former CFO, arising from illicit cash payments made to Brazilian customs officials by a subsidiary of the company and accompanying falsification of the company's accounting records.[62] In a notable twist, the complaint alleges that the CEO (who was serving as COO and director at the time of the offenses) and former CFO violated the books-and-records and internal controls provisions of the FCPA solely in their capacities as "control persons" of the company. In other words, they were not charged with engaging directly in the alleged wrongdoing, but rather for failing to supervise senior management and compliance with corporate compliance policies. Observers believe that this is a real "message" case aimed at senior executives and board members, because it seems to constitute the first time the SEC has charged individuals with FCPA violations on a control-person liability theory.

- In February 2009, Kellogg, Brown & Root LLC pleaded guilty to criminal violations of the FCPA, agreeing to pay a criminal fine of $402 million and to retain an independent monitor to review its FCPA compliance policies and procedures. The company's former parent, Halliburton Co., and its current parent, KBR, Inc., settled (without admitting or denying culpability) related SEC civil FCPA charges. Specifically, the SEC alleged that the company bribed Nigerian government officials over a 10-year period in order to obtain construction contracts worth more than $6 billion. Among several other charges, the SEC maintained that former parent Halliburton allegedly failed to maintain adequate internal controls to detect or prevent the bribery of Nigerian officials and payments made to two foreign sales agents, resulting in false books and records. Both Halliburton and successor parent company KBR, Inc. settled SEC books-and-records and defective accounting controls claims, agreeing to entry of a permanent injunction, disgorgement of $177 million in illicit profits, the retention of an external compliance monitor in the case of KBR Inc. for three years and the retention of a consultant for Halliburton to conduct an independent review of FCPA compliance policies and procedures. One of the most important lessons of this case: acquirors should conduct painstaking due diligence in situations where, as here, the target company engages in lucrative business in developing, high bribery-risk countries, both to avoid successor liability for pre-acquisition violations, and continuing liability for bribery-tainted contracts, licenses and the like should the conduct continue undetected after consummation.[63]

(7) Insider Trading

The Enforcement Division continues its vigorous pursuit of insider trading, including tipping, in some instances pushing into new territory.

- As discussed above, the SEC brought (and settled) its first case challenging insider trading in the CDS market, demonstrating the agency's willingness to extend the boundaries of its enforcement jurisdiction well beyond the equity markets.
- The Galleon case[64] scooped up in the enforcement net, along with hedge fund traders and other market professionals, senior executives of IBM, Intel, Atheros Communications and McKinsey & Co. (and implicated an unnamed executive at Akamai Technologies) for illegal tipping and/or trading. These charges of massive fraud involving senior corporate managers send a clarion call to corporate management and boards to fight complacency and recognize the heightened risks of fraud during an economic downturn, and to act promptly to review and strengthen both anti-tipping and anti-trading measures in their insider trading and Regulation

FD policies to protect the corporation against the unauthorized actions of a few. The clear benefits of such preemptive diligence are demonstrated by the FD case discussed above, in which American Commercial Lines was able to avoid civil prosecution for an unauthorized selective disclosure to analysts of material, non-public earnings information by a former CFO.

- The Mozilo/Countrywide complaint primarily focuses on alleged securities fraud violations by the former CEO of Countrywide Financial Corporation, Angelo Mozilo, and several other former executives of the company, alleging that these individuals deliberately misled investors about the significant credit risks being taken to build in order to maintain the company's market share shortly before the U.S. housing market began its downward spiral. However, the accompanying insider trading charges against Mr. Mozilo are perhaps even more noteworthy, in the sense that they demonstrate the SEC's resolve to follow through on repeated warnings from Enforcement Division senior staff that the agency would challenge insider abuses of 10b5-1 trading plans. The SEC's complaint alleges that Mr. Mozilo established and/or amended four of these plans over a period of several months in late 2006 and early 2007, when he was aware of material, non-public information regarding Countrywide's mounting credit risk and the expected poor performance of company-originated loans; he is alleged to have exercised more than 5.1 million options and sold the underlying shares pursuant to these plans for total proceeds of nearly $140 million.[65] This case underscores the wisdom of reassessing the effectiveness of corporate policies and procedures relating to insider trading, specifically to ensure that officer and director pre-clearance provisions apply to insiders' creation and material modification of these plans at times when members of senior management and/or the board of directors may be aware of material, not-yet disclosed developments within or affecting the company. See **Part IV.D.5** above.

(8) "Traditional" Fraudulent Disclosure Cases

Director Khuzami has emphasized that the creation of specialized units to attack wrongdoing in particular sectors will not detract from the Division's continued, zealous pursuit of more traditional antifraud disclosure cases, ranging from proxy rule violations to fraudulent financial reporting. Just two examples are set forth below, in addition to those discussed above resulting from the financial market meltdown, to highlight the variety of cases being instituted:

- In August 2009, the SEC announced the filing and settlement of a civil injunctive action in the Southern District of New York against Bank of America for misleading investors about the payment of about several billion dollars in bonuses to Merrill Lynch executives in the joint proxy statement filed to solicit the votes of shareholders of both companies in connection with BoA's acquisition of Merrill.[66] (Shareholders approved the acquisition, which closed in January 2009). According to the SEC's complaint, BoA represented in the signed merger agreement, which had been filed with the SEC, that Merrill had agreed not to pay its executives any bonuses before the deal closed following the shareholder vote, whereas in fact – as reflected in an undisclosed schedule to the merger agreement – BoA had agreed that Merrill could pay up to $5.8 billion of such bonuses. Presiding Judge Jed Rakoff ultimately rejected the settlement agreement, questioning the SEC's decision to impose a corporate penalty of $33 million on BoA rather than pursuing individual executives or the company's outside counsel who had given disclosure advice.[67] The SEC filed an amended complaint this October, and a March 2010 trial date has been set.[68]

- Also in August 2009, the SEC sued former AIG Chairman and CEO Maurice (Hank) Greenberg and former CFO Howard Smith for their involvement in "numerous improper accounting transactions that inflated AIG's reported financial results between 2000 and 2005." Alleging violations of the antifraud and books-and-records/internal accounting controls provisions of the Exchange Act, the SEC's complaint charges that the defendants were responsible for material misstatements that enabled AIG "to create the false impression that the company consistently met or exceeded key earnings and growth targets," in some instances through sham third-party transactions.[69]

(9) Regulation 13D/G

As the SEC considers ways to expand the beneficial ownership reporting obligations of large stockholders in response to the use of equity-based derivatives to magnify economic and/or voting power (see **Part III.H.2.** above), the agency is vigorously pursuing violations of the existing rules. To illustrate:

- A case brought against Tracinda Corporation sends the message that "boilerplate" disclosures in 13D/G filings, and untimely amendments, will not be tolerated. In September 2008, the SEC announced a cease-and-desist settlement with Tracinda for certain alleged Schedule 13D reporting violations concerning untimely disclosure of its plan and proposal to sell 28 million shares of General Motors stock. In November 2006, Tracinda filed an amendment to its Schedule 13D announcing the sale of 14 million shares of GM stock. However, the amendment did not disclose that it had previously made a proposal to sell 28 million GM shares, which the SEC deemed violative of Exchange Act Section 13(d)(2) and Rule 13d-2(a). The SEC further charged that the "boilerplate" language in Tracinda's filing that it "may … acquire or dispose of additional shares" – when there was only a remote possibility that it would buy additional shares – was misleading and violated Rule 12b-20.[70] It has been observed that this case prompted a change in beneficial ownership reporting practices by hedge funds and other large institutional investors.
- A case against Perry Corporation may be a harbinger of the more expansive disclosure requirements likely to come in this area. In July 2009, the SEC announced a settlement with Perry regarding certain Schedule 13D violations for failing to report that it had purchased more than 5% of Mylan Laboratories stock for the purpose of voting such shares in favor of an announced proposed merger. The SEC stated that when investors acquire securities for the purpose of affecting or influencing the outcome of a transaction, the shares are not held in the "ordinary course" of business and, as a result, the investor is not entitled to defer its reporting obligations. Rather, Perry was required to disclose its acquisition of more than 5% of Mylan shares within 10 days of the acquisition and, by failing to do so, violated Exchange Act Section 13(d) and Rule 13d-1.[71]

C. Congressional Initiatives to Strengthen and Expand SEC Enforcement Powers

The House of Representatives has passed and the Senate is considering, comprehensive financial reform bills that (among many other things) would significantly expand the SEC's enforcement authority in certain areas, and substantially increase the resources available to the agency for law-enforcement functions. Despite some differences in other areas, the House bill and the Senate discussion draft contain a number of similar provisions that would strengthen the SEC's enforcement powers – in apparent response to the SEC's request[72] – by:

- Expanding the SEC's access to grand jury materials relating to securities laws violations via court order.
- Granting the SEC's wish of restoring a private right of action for antifraud aiding and abetting liability, thus overturning Supreme Court precedent, and empowering the SEC to restrict mandatory arbitration of investor disputes with broker-dealers, thereby enabling investors to seek recourse in the courts (the SEC views private antifraud litigation as an important supplement to its own enforcement program).
- Extending the SEC's aiding and abetting enforcement authority under the Securities Act of 1933 and the Investment Company Act of 1940, and clarifying the scope of such authority under the Investment Advisers Act of 1940.
- Providing the SEC with clear regulatory and enforcement authority over securities-based swaps and other derivative products.
- Enhancing the SEC's authority under the Exchange Act and the Advisers Act to impose collateral bars on officers and directors of broker-dealers and investment advisers.
- Expanding the SEC's power to compensate whistleblowers, and giving such whistleblowers a new private right of action against employers that take retaliatory action.
- Allowing the SEC to become self-funded (Senate), or substantially increasing funds appropriated for the SEC (House), which in either case would increase the resources available to the agency for both law-enforcement and regulatory functions.

The House bill also would establish specific deadlines for completing SEC enforcement investigations and compliance examinations and inspections of broker-dealers and other regulated entities or persons. In addition, the bill would provide for nationwide service of subpoenas by the SEC and authorize the imposition of higher penalties in administrative cease-and-desist proceedings brought by the SEC under various provisions of the federal securities laws.

* * *

If you have any questions about these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

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ENDNOTES

[1] *See* SEC Release No. 33-9089 (Dec. 16, 2009), available at http://www.sec.gov/rules/final/2009/33-9089.pdf.

[2] *See* SEC Staff Compliance and Disclosure Interpretations – Proxy Disclosure Enhancements Transition (Dec. 22, 2009), available at http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm.

[3] Directors and nominees may be concerned that the disclosure of certain experience and capabilities (*e.g.*, expertise as an investment banker) may inappropriately suggest that such person bears greater responsibility for certain decisions than other board members due to his or her expertise in a particular area, and therefore is subject to a higher degree of liability. A similar concern was raised in 2002 when the SEC proposed rules requiring disclosure of the name of a company's audit committee financial expert (if any). In that case, the SEC addressed this issue by stating that such identification does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and the board of directors in the absence of such designation or identification. The new rules do not include such a safe harbor but no negative implication of greater responsibility appears to have been intended.

[4] *See* New York Stock Exchange Listed Company Manual Section 330A.07(c)(iii)(D), available at www.nyse.com.

[5] The amendments, among other things, (1) align the timing of disclosure of code of business conduct and ethics waivers with Form 8-K and eliminate NYSE disclosure requirements *(e.g.*, categorical standards for independence determinations) that are duplicative of those in Item 407 of SEC Regulation S-K, (2) expand the ability of companies to use their websites rather than SEC filings to disclose certain governance information and eliminate the requirement that companies offer to provide free hard copies of posted governance documents, and (3) eliminate the requirement in Listed Company Manual Section 303A.12(a) to disclose in the annual report whether a company has submitted to the NYSE an annual written affirmation as to compliance with the NYSE's corporate governance listing standards and any qualifications to that affirmation. The changes to the NYSE's corporate governance listing standards are summarized in our briefing of December 7, 2009 available at http://www.weil.com/news/pubdetail.aspx?pub=9667.

[6] See Board of Governors of the Federal Reserve System, Proposed Guidance on Sound Incentive Compensation Policies (Docket No. OP-1374), published on October 22, 2009, and available at http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm. The comment period on the proposed guidance ended on November 27, 2009. Another helpful resource in considering risk and compensation policies and practices is the Center on Executive Compensation's "Compensation Committee Checklist for Assessing Incentives and Risk," which is available at http://www.execcomp.org/docs/c09-16%20compensation_committee_checklist.pdf.

[7] Our December 11, 2009 Briefing relating to pending House and Senate bills on compensation committees' retention of outside compensation consultants is available at http://www.weil.com/files/upload/Weil_Briefing_Corp_Gov_2009_Dec_14_.pdf.

[8] *See* speech by Shelley Parratt, Deputy Director, SEC Division of Corporation Finance, Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010 (Nov. 9, 2009), available at http://www.sec.gov/news/speech/2009/spch110909sp.htm.

[9] *See id.*

[10] *See id.*

[11] RiskMetrics Group, *Postseason Report October 2009* ["RiskMetrics Postseason Report"] at 17; Georgeson, *2009 Annual Corporate Governance Review* at 6.

[12] *See* The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111 Cong. (1st Sess. 2009) § 7222 (authorizing the SEC to establish access rules) passed by the House of Representatives on Dec. 11, 2009; Discussion Draft of the Restoring American Financial Stability Act of 2009 § 972 (requiring the SEC to adopt rules establishing access for most publicly owned companies) introduced in the Senate on Nov. 10, 2009 by Senator Dodd.

[13] Delaware General Corporation Law ["DGCL"] § 112 (77 Del. Laws, c. 14 § § 1, 2).

[14] *See* American Bar Association ["ABA"] Section of Business Law Committee on Corporate Laws, "Changes in the Model Business Corporation Act –Proposed Amendments to Chapters 8 and 10 Relating to Voting By Shareholders on the Election of Directors" (March 13, 2006), *available at* < http://www.abanet.org/buslaw/committees/CL270000pub/directorvoting/20060313000001.pdf >.

[15] ABA Section of Business Law Committee on Federal Regulation of Securities Task Force on Shareholder Proposals, "Illustrative Access Bylaw with Commentary" (June 15, 2009), *available at* < http://meetings.abanet.org/webupload/commupload/CL410000/sitesofinterest_files/illustrative_access_bylaw.pdf >.

[16] *See* SEC Rel. 34-60089 (June 10, 2009) § III.C.2 and IX.

[17] DGCL § 113.

[18] *See* Section 3.4 of the Amended and Restated Bylaws of HealthSouth Corporation filed as Exhibit 3.3 to the Quarterly Report on Form 10-Q dated November 4, 2009 of HealthSouth Corporation.

[19] *See* SEC Release No. 33-9052 (July 10, 2009), available at http://www.sec.gov/rules/proposed/2009/33-9052.pdf.

[20] *See id.*

[21] *See* Application of Rule 14a-4(d)(4) to Solicitation for Proposed Minority Slate of Icahn, SEC No-Action Letter (Mar. 30, 2009), *available at* http://www.sec.gov/divisions/corpfin/cfnoaction/2009/icahnassociates033009-12h3.htm; and Application of Rule 14a-4(d)(4) to Solicitation for Proposed Minority Slate of Eastbourne Capital, L.L.C., SEC No-Action Letter (Mar. 30, 2009), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2009/eastbournecapital033009-sec14.htm.

[22] *See* SEC Release No. 33-9073 (Oct. 14, 2009), available at http://www.sec.gov/rules/proposed/2009/33-9073.pdf.

[23] RiskMetrics Postseason Report at 5, 6.

[24] RiskMetrics Postseason Report at 4-6.

[25] In 2007, support averaged somewhat below 42% over 41 proposals. RiskMetrics Postseason Report at 5, 6, 24.

[26] RiskMetrics Postseason Report at 24.

[27] *See id.*

[28] *See id.*

[29] *See* Staff Legal Bulletin No. 14E(CF) Shareholder Proposals, published on October 27, 2009 and available at http://www.sec.gov/interps/legal/cfslb14e.htm.

[30] Data relates to director elections where the voting results were available as of October 5, 2009 and was derived from the Governance Analytics section of the RiskMetrics website (www.riskmetrics.com) (log-in required). *See also* RiskMetrics Group, *Postseason Review: Withhold Votes*, RISK & GOVERNANCE WEEKLY (Oct. 2, 2009).

[31] RiskMetrics Postseason Report at 10.

[32] The policy updates applicable to U.S. companies, issued on November 19, 2009, are available at http://www.riskmetrics.com/sites/default/files/RMG2010USPolicyUpdates.pdf and are summarized in our briefing of November 23, 2009 available at http://www.weil.com/updates-for-2010-proxy-season/. On November 19, 2009, RiskMetrics also released a set of frequently asked questions in relation to its evaluation of compensation practices for U.S. companies, which is available at http://www.riskmetrics.com/sites/default/files/RMG2010CompensationFAQ.pdf.

[33] RiskMetrics recently issued guidelines with respect to engaging with RiskMetrics on proxy voting matters, which are available at http://www.riskmetrics.com/sites/default/files/ProcessForEngagingOnProxyVoting20090130.pdf.

[34] *See* Goldman Sachs, December 10, 2009 Press Release, available at http://www2.goldmansachs.com/our-firm/press/press-releases/current/compensation.html.

[35] The SEC, through its Division of Corporation Finance, is statutorily obligated to review the Form 10-Ks and other Exchange Act reports filed by listed companies at least once every three years. *See* Section 408(a) of The

Sarbanes-Oxley Act of 2002, now codified at 15 U.S.C.A. Section 7266. The Division may choose to review the Exchange Act reports and other filings of an individual company more than once during any given three-year period, based on the Division's internal, non-public review criteria and consideration of such potentially relevant facts and circumstances as whether the company has changed its outside auditor or restated its financial statements.

[36] The only specific guidance appears in Item 503(c) of Regulation S-K, which calls for a concise, logically organized and company-tailored discussion of "the most significant factors" that make an offering "speculative or risky."

[37] *See* Speech by SEC Commissioner Elisse B. Walter, before the 48th Annual Corporate Counsel Institute, "*SEC Rulemaking – 'Advancing the Law' to Protect Investors"* (Chicago, Illinois; Oct. 2, 2009) ("Walter Speech"), available at http://www.sec.gov/news/speech/2009/spch100209ebw.htm; SEC Investor Advisory Committee, "*Possible Refinements to the Disclosure Regime*" at 6-8 (2009), available at http://www.sec.gov/spotlight/invadvcomm/iacmeeting072709-briefingpaper.pdf. *See also* SEC File No. 4-547 (Nov. 24, 2009), Supplemental Petition for Interpretive Guidance on Climate Risk Disclosure (Nov. 24, 2009), filed by CERES, CALPERS, the New York Attorney General, and a variety of other institutional investors and organizations, available at http://www.sec.gov/rules/petitions/2009/petn4-547-supp.pdf (the original petition was filed in 2007 and is available at http://www.sec.gov/rules/petitions/2007/petn4-547.pdf).

[38] Walter Speech, *supra* note 37.

[39] PCAOB Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Environment* (Dec. 5, 2008).

[40] Under former FASB Statement of Financial Accounting Standards No. 142, now found at FASB Accounting Standards Codification Topic 350, goodwill must be tested for impairment at the "reporting unit" level; a reporting unit is defined as an operating segment or one level below (known as "component" level). Improper aggregation makes it easier to reduce the potential impact of an incipient impairment.

[41] Walter Speech, *supra* note 37. The SEC staff expects pre-accrual disclosure in the MD&A of contingent litigation losses if there is a reasonable likelihood (but not yet a probability) that any such losses (if realized) would have a material adverse effect on a company's financial condition or results of operations. GAAP likewise requires a company to make certain pre-recognition disclosures in the financial statement footnotes if the risk of loss is "reasonably possible", but still less than "probable" (which would compel recognition). *See* FASB Accounting Standards Codification Subtopic 450-20 (formerly known as FASB Statement of Financial Accounting Standards No. 5); *see also* FASB Accounting Standards Codification, which includes former FSP 141R-1 (latest statement from FASB on accounting treatment of acquired loss contingencies). Those companies concerned that, until late August 2009, FASB had appeared poised to adopt a new accounting standard in this area that would have jeopardized their ability to mount a defense in pending and future lawsuits (by compelling a waiver of attorney-client privilege to effect the requisite GAAP disclosure) have been given a reprieve in connection with the 2010 Form 10-K financial statements. At an August 19, 2009 meeting, FASB announced that it decided not to compel disclosures that would have a prejudicial impact on litigation, and that such disclosures instead should include both qualitative and quantitative information about the loss contingency sufficient to enable a reader of the financial statements to understand the nature of the contingency and its potential timing and magnitude. FASB directed its staff to go back to the drawing board and consider several different approaches, none of which seems likely to require companies to disclose privileged information bearing on actual or potential litigation, either to their auditors or the public. In the meantime, companies should continue to follow existing GAAP in this area. For more on the status of this project, see "Project Updates – Disclosure of Certain Loss Contingencies" (last updated Oct. 14, 2009), available at http://www.fasb.org/accounting_for_contingencies.shtml.

[42] SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, at Topic 11.M., available at http://www.sec.gov/interps/account/sabcodet11.htm#11m (requiring companies to disclose, in the MD&A, as well as the financial statement footnotes, the potential effect(s) of newly adopted GAAP on financial position and results of operations, unless not expected to be material). In June 2009, FASB issued two new standards that will change significantly – beginning January 1, 2010 for calendar-year reporting companies – how and when many public companies must consolidate so-called "variable-interest entities" (*e.g.* off-balance sheet arrangements), and also will tighten up on the requirements for derecognition of financial assets and liabilities that have been criticized for making it far too easy to invoke "sale" accounting to support deconsolidation. *See* FASB Accounting Standards Codification Topics 810 and 860.

[43] *See* Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses (Aug. 2009), available at http://www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm. A cautionary statement that appears at the end of this "Dear CFO" Letter, which outlines various suggestions for MD&A disclosure, bears repeating: "Finally, although determining your allowance for loan losses requires you to exercise judgment, it would be inconsistent with … [GAAP] if you were to delay recognizing credit losses that you can estimate based on current information and events. Where we believe a financial institution's financial statements are inconsistent with GAAP, we will take appropriate action."

[44] *See* SEC Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Rel. No. 33-8350 (Dec. 19, 2003), available at http://www.sec.gov/rules/interp/33-8350.htm.

[45] *See id.*

[46] *See id.*

[47] *See* Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)(Sept. 2008), available at http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm; Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)(March 2008), available at http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm.

[48] *See* Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities)(Dec. 2007), available at http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceletr1207.htm.

[49] *See* PCAOB Rel. No. 2009-006, Report on The First-Year Implementation of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements* (Sept. 24, 2009), available at http://www.pcaobus.org/Inspections/Other/2009/09-24_AS5_4010_Report.pdf. Companies should be aware that findings of serious audit deficiencies made by PCAOB staff in the context of inspecting registered accounting firms may reveal instances of management misapplication of GAAP that, in turn, could lead to referrals to the SEC's Office of the Chief Accountant. Accordingly, audit committees responsible for oversight of the external audit engagement should take steps to ensure that the outside auditor undertakes to advise the audit committee or its Chair if the particular client's financial statements (and ICFR) are subject to PCAOB scrutiny and, if feasible (not all accounting firms will agree to this), to communicate any material deficiencies identified by the PCAOB during the inspection process.

[50] *See* Remarks of Robert Khuzami, Director, SEC Division of Enforcement, at the AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 8, 2009), available at http://www.sec.gov/news/speech/2009/spch120809rsk.htm. *See, e.g.,* note 66 and accompanying text.

[51] *See generally Recent BofA Decision Will Not Change Case Resolution Process, Khuzami Says*, 7 CARE 1201 (Oct. 9, 2009) (reporting comments made by Mr. Khuzami on the Bank of America case during an American Bar Association teleconference broadcast on October 1, 2009). The ruling in question, issued this September by U.S. District Court Judge Jed Rakoff of the Southern District of New York, can be found at *SEC v. Bank of America Corp.*, Memorandum Order, No. 09 Civ. 6829 (S.D.N.Y. Sept. 14, 2009) ("BoA Order").

[52] *See* Remarks by Robert Khuzami, Director, SEC Division of Enforcement, before the Bar of the City of New York, *My First 100 Days as Director of Enforcement* (Aug. 5, 2009, New York, New York) ("Khuzami, First 100 Days"), available at http://www.sec.gov/news/speech/2009/spch101509rk.htm.

[53] *See id.*

[54] *See id.* The Seaboard Report is a Report of Investigation issued by the SEC under Section 21(a) of the Exchange Act, in connection with a settled action brought against an employee of a subsidiary of the Seaboard Corporation. *See* In the Matter of Gisela de Leon Meredith, SEC Rel. No. 34-44970 (Oct. 23, 2001). Because of its extensive cooperation with the SEC, the agency decided not to sue Seaboard and used the 21(a) Report to explain this exercise of prosecutorial discretion so that other companies would take similar steps in the future upon uncovering credible evidence of securities law violations.

[55] *See* SEC v. Jenkins, Case No. 2:09-cv-10510-JWS (D. Ariz. July 23, 2009), available at http://www.sec.gov/litigation/complaints/2009/comp21149.pdf. The SEC brought and settled an administrative

proceeding against the company earlier this year. *See* In the Matter of CSK Auto Corp., File No. 3-13485 (SEC May 29, 2009), available at http://www.sec.gov/litigation/admin/2009/33-9032.pdf.

[56] Robert Khuzami, Director, SEC Division of Enforcement, at Department of Justice Press Conference (Nov. 17, 2009), available at http://www.sec.gov/news/speech/2009/spch111709rsk.htm. *See* Joint Press Release of the Department of Justice, the Department of the Treasury, the Department of Housing and Urban Development, and the Securities and Exchange Commission, *President Obama Establishes Interagency Financial Fraud Enforcement Task Force* (Nov. 17, 2009), available at http://www.sec.gov/news/press/2009,2009-249.htm.

[57] Remarks of SEC Enforcement Division Director Robert Khuzami, in announcing the charges. SEC Press Rel. No. 2009-146 (Jul. 1, 2009), available at http://www.sec.gov/news/press/2009/2009-146.htm. *See* SEC v. Michael T. Rand, SEC Lit. Rel. No. 21114 (Jul. 1, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21114.htm. The SEC settled an administrative proceeding against Beazer Homes in 2008, alleging various disclosure violations involving, among other tactics, use of "cookie-jar" reserves techniques to increase net income during a period of declining profitability as the housing market crashed. Beazer neither admitted nor denied the SEC's charges. *See* In the Matter of Beazer Homes USA, Inc., SEC Rel. No. 33-8960 (Sept. 24, 2008)(instituting and settling cease-and-desist proceeding), available at http://www.sec.gov/litigation/admin/2008/33-8960.pdf.

[58] SEC v. Brookstreet Securities Corp. and Stanley C. Brooks, Case No. SACV 09-01431 DOC (ANX)(C.D. Cal. Dec. 8, 2009), complaint available via SEC Lit. Rel. No. 21328 (Dec. 8, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21328.htm.

[59] *See* SEC Lit. Rel. No. 21023 (May 5, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21023.htm.

[60] SEC Lit. Rel. No. 21222 (Sept. 24, 2009), announcing the institution and settlement of SEC v. Christopher A. Black, Case No. 09-CV-0128 (S.D. Ind., Sept. 24, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21222.htm.

[61] *See* SEC Lit. Rel. No. 21290 (Nov. 12, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21290.htm (announcing that the SEC had charged Safenet, together with the former CEO and former CFO, with antifraud, books-and-records, and other federal securities laws violations, in addition to the violation of Regulation G arising out of the same misconduct. Three former accountants also were charged for their roles in the earnings management scheme).

[62] *See* SEC Lit. Rel. No. 21162 (July 31, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21162.htm. ;

[63] *See* SEC v. Halliburton Co. and KBR, Inc., SEC Lit. Rel. No. 20897A (Feb. 11, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr20897a.htm.

[64] *See* SEC Press Rel. No. 2009-235 (Nov. 5, 2009), (announcing additional charges in its insider trading case against billionaire Raj Rajaratnam and his hedge fund, Galleon Management LLP, and charging 13 additional individuals and entities), available at http://www.sec.gov/news/press/2009/2009-235.htm; SEC Press Rel. No. 2009-221 (Oct. 16, 2009) (announcing the filing of a civil fraud complaint against Galleon, Mr. Rajaratnam and six others allegedly involved in the scheme, including senior executives at major companies IBM, Intel and McKinsey & Co.), available at http://www.sec.gov/news/press/2009/2009-221.

[65] *See* SEC v. Mozilo, et. al, No. CV 09-03994 (VBF) (C.D. Cal., filed June 4, 2009), as discussed in SEC Lit. Rel. No. 21068A (June 4, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21068a.htm.

[66] *See* SEC Press Release No. 2009-177 (Aug. 3, 2009), available at http://www.sec.gov/news/press/2009/2009-177.htm; SEC Lit. Rel. No. 21164 (Aug. 3, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21164.htm.

[67] BoA Order, *supra* note 51.

[68] *See* Robert Khuzami, Director, SEC Division of Enforcement, *Testimony Concerning Events Surrounding Bank of America's Acquisition of Merrill Lynch*, before the House Oversight and Government Reform Committee and Domestic Policy Subcommittee (Dec. 11, 2009), available at http://www.sec.gov/news/testimony/2009/ts121109rk.htm.

[69] SEC Lit. Rel. No. 21170 (Aug. 6, 2009), available at http://www.sec.gov/litigation/litreleases/2009/lr21170.htm.

[70] *See* SEC Rel. No. 34-58451 (Sept. 3, 2008), available at http://www.sec.gov/litigation/admin/2008/34-58451.htm.

[71] *See* SEC Press Rel. No. 2009-165 (Jul. 21, 2009), available at http://www.sec.gov/news/press/2009/2009-165.htm.

[72] *See* Robert Khuzami, Director, SEC Division of Enforcement, Testimony Concerning Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting Those Responsible, before the U.S. Senate Committee on the Judiciary (Dec. 9, 2009), available at http://www.sec.gov/news/testimony/2009/ts120909rk.htm (indicating that the SEC had asked Congress to establish a whistleblower program, permit the SEC to obtain improved access to grand jury materials, provide for nationwide service of process in judicial actions, and allow the SEC to charge aiding and abetting violations under the Securities Act of 1933 and the Investment Company Act of 1940, and to seek penalties against aiders and abettors under the Investment Advisers Act of 1940. The SEC also has expressed support for current proposed legislation to regulate over-the-counter derivatives).